Petition and Transcript of Record

Supreme Court of the United States

OCTOBER TERM, 1931

No. 634

THE TEXAS & PACIFIC RAILWAY COMPANY, PETITIONER,

vs.

THE UNITED STATES.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED JANUARY 14, 1932.

CERTIORARI GRANTED FEBRUARY 15, 1932.

(36,448)

(36,448)

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[fol. 1]

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1931

No. 634

THE TEXAS & PACIFIC RAILWAY COMPANY, Petitioner,

vs.

THE UNITED STATES, Respondent

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, The Texas & Pacific Railway Company, prays that a writ of certiorari issue to review the judgment of the Court of Claims of the United States entered in the above entitled case on October 20, 1931, and in support thereof, respectfully shows:

Summary Statement of Matter Involved

This is a suit brought in the Court of Claims to recover income and excess profits taxes in the sum of $208,138.01, part of the total taxes paid by the petitioner for the year [fol. 2] 1920, alleged to have been erroneously and illegally assessed and collected under the provisions of the Revenue Act of 1918, Act of Cong. February 24, 1919, c. 18, 40 Stat. 1057.

The petitioner is a railroad corporation and during the months of January and February, 1920, its properties were operated by the Director General of Railroads under the Federal Control Act, Act of Cong. March 21, 1918, c. 25, 40 Stat. 451. During the remainder of the calendar year 1920 the petitioner was operated by a receiver under a decree of court. Federal control terminated on February 29, 1920.

Under the Federal Control Act, the petitioner had a contract fixing the amount of just compensation during the Federal control period. The Transportation Act, 1920, Act of Cong. February 28, 1920, c. 91, 41 Stat. 456, termi-

nated the Federal control of railroads, and carriers, fulfilling certain conditions, were guaranteed a subsidy under the Act for the six months period after Federal control ceased, called the "guaranty period."

Under the provisions of the Transportation Act, 1920, the petitioner elected to take the guaranty provided by Section 209 (c) (1). Under that Section the United States guaranteed for the "guaranty period" as a whole, an amount not less than one-half of the annual amount named in the Federal control contract, such amount being determined as provided in the Act.

[fol. 3] Under this guaranty the United States paid the petitioner $2,043,041.77 and one of its subsidiaries $18,040.86, a total of $2,061,082.63. These amounts were included in gross income in the income tax returns filed for the year 1920.

The Commissioner of Internal Revenue upon audit consolidated the petitioner and its subsidiaries and determined a consolidated net income of $3,639,968.48 and assessed taxes of $363,796.85, for the year 1920. In this determination the Commissioner included as income the aggregate sum of $2,061,082.63, shown above.

The taxes so assessed by the Commissioner for the year 1920 were duly paid and two claims for refund were filed, one for the sum of $206,108.26 based upon the inclusion as income of the guaranty payments, and the other for $2,029.75 based upon minor items in the audit. The claims were rejected by the Commissioner of Internal Revenue and suit was filed in the Court of Claims.

That court rendered judgment for the petitioner in the sum of $1,962.90, sustaining the petitioner's contentions as to the minor items, but the court held that the $2,061,082.63 paid by the United States under the guaranty was taxable as income.

[fol. 4] Reasons Relied on for the Allowance of the Writ

1. This case presents for decision a principle of Federal law which involves the taxability for Federal income purposes of many millions of dollars paid by the United States to railroads under the guaranty provisions of Section 209 of the Transportation Act, 1920.

2. The question in this case is whether the amount of $2,061,082.63 paid by the United States as a subsidy to the

petitioner and its subsidiary under Section 209 (c) (1) of the Transportation Act, 1920, was taxable as income within the meaning of the Sixteenth Amendment and the provisions of the Revenue Act of 1918.

3. The question is one of large importance and wide public interest and has never been decided by this Court.

4. A final decision by this Court is necessary to settle other similar cases pending in the Federal Courts, before the United States Board of Tax Appeals and in the Bureau of Internal Revenue.

5. As shown by the debates in Congress (Cong. Rec. Vols. 58 and 59) the amounts paid to the petitioner and other railroads under Section 209 of the Transportation [fol. 5] Act, 1920, were in fact Government subsidies, were so intended, and were not income subject to tax.

6. The Court of Claims failed to follow the decisions of this Court wherein "income" has been repeatedly defined. The Court erroneously held that the amount paid to the petitioner and its subsidiary by the United States was taxable income.

Wherefore your petitioner prays that a writ of certiorari be issued out of and under the seal of this Honorable Court directed to the Court of Claims of the United States to review the judgment, record and proceedings had therein, and for such other, further and general relief, as to this Court may seem just and proper in the premises.

Respectfully submitted,

The Texas & Pacific Railway Company, by Adrian C. Humphreys, Adrian C. Humphreys, Newton K. Fox, Attorneys.

[fol. 1] IN THE COURT OF CLAIMS

No. K-148

THE TEXAS & PACIFIC RAILWAY COMPANY, Plaintiff,

v.

THE UNITED STATES

I. PETITION—Filed April 23, 1929

To the Honorable the Court of Claims:

The plaintiff in the above-entitled cause respectfully represents:

I

That it is a railroad corporation organized and existing under and by virtue of an Act of the Congress approved March 3, 1871, and having its principal office and place of business at Dallas, Texas.

II

That during the months of January and February, 1920, the plaintiff's properties were under Federal Control and operated by the Director General of Railroads; that during the remainder of the calendar year 1920 the plaintiff's properties were operated by a receiver under a decree of the District Court, Western District of Louisiana, Monroe Division, and that the receivership terminated at midnight on May 14, 1924.

III

That this suit arises under the Revenue Laws of the United States and is for the recovery of alleged income [fol. 2] taxes illegally and erroneously assessed against and collected from the plaintiff by the defendant under the alleged authority of the Revenue Act of 1918.

IV

That the plaintiff accepted the provisions of Section 209 of the Transportation Act, 1920 (41 Stat. L. 464); and for the so-called "Guaranty Period" the plaintiff received an allowance by the Interstate Commerce Commission, as representing the amount necessary to make good the guaranty under said Section 209 of the Transportation Act, 1920, in the sum of $2,043,041.77 and that the plaintiff's subsidiary The Denison & Pacific Suburban Railway Company received a like allowance in the sum of $18,040.86.

V

That on the form prescribed for that purpose the plaintiff filed with the Collector of Internal Revenue at Dallas, Texas, on March 15, 1921, its income and profits tax return for the year 1920; that said return reported a taxable net income of $3,331,767.11 and a tax liability of $332,976.71 and that said tax liability was paid to the said Collector of

Internal Revenue on the following dates and in the following amounts, to wit:

March 15, 1921	$83,244.18
June 4, 1921	83,244.17
September 7, 1921	83,244.18
December 10, 1921	83,244.18

and that said amounts were duly paid in to the Treasury of the United States by said Collector.

[fol. 3]

VI

That plaintiff's subsidiaries, The Weatherford Mineral Wells and Northwestern Railway Company and The Denison & Pacific Suburban Railway Company filed their respective income and profits tax returns for the year 1920 with the said Collector of Internal Revenue at Dallas, Texas, on March 5, 1921, and March 15, 1921; that said returns reported losses in the respective amounts $10,114.53 and $562.23; and that neither of said returns disclosed any tax liability.

VII

That under date of November 20, 1925, the Commissioner of Internal Revenue, upon audit of said returns, consolidated said returns and determined a consolidated net income of $3,858,969.80 and an alleged additional tax liability of $52,720.27; that among the adjustments set forth in said audit the Commissioner erroneously included as taxable net income the sum of $17,707.97 representing donations to the plaintiff in the form of spur tracks, side tracks, and other improvements.

VIII

That thereafter, under date of December 30, 1926, the said Commissioner made a revised audit of the returns of the plaintiff and its subsidiaries, and determined a consolidated net income of $3,586,524.78 and an alleged additional tax liability of $25,475.77 in lieu of his determination as set forth in his letter dated November 20, 1925; that in the revised audit set forth in said letter of December 30, 1926, the Commissioner erroneously disallowed as a deduction [fol. 4] from gross income the sum of $2,589.55 represent-

ing a portion of an assessment paid to the Association of Railway Executives of which plaintiff is a member.

IX

That thereafter, under date of April 8, 1927, the Commissioner of Internal Revenue made his final determination of plaintiff's tax liability for the year 1920; that said final determination was based upon a consolidated net income of $3,639,968.48; that the total tax liability as finally determined in said letter was allocated by the Commissioner to the plaintiff and its subsidiary, The Weatherford Mineral Wells and Northwestern Railway Company in the respective amounts $361,797.42 and $1,999.43; and that based upon said allocation the Commissioner determined a deficiency against the plaintiff in the sum of $28,820.71 and a deficiency against the said subsidiary in the sum of $1,999.43; and that said deficiency of $28,820.71 was paid to the said Collector of Internal Revenue at Dallas, Texas, on May 6, 1927, and was duly covered into the Treasury of the United States.

X

That the consolidated net income of the plaintiff and its subsidiaries, as finally determined by the Commissioner in his letter dated April 8, 1927, erroneously included as taxable income the said allowance on account of the "Guaranty Period" in the aggregate sum of $2,061,082.63 as well as the said items of donations in the sum of $17,709.97 and the said payment to the Association of Railway Executives in the sum of $2,589.55.

[fol. 5]

XI

That under date of June 21, 1927, on the form prescribed for that purpose, plaintiff filed with the Collector of Internal Revenue at Dallas, Texas, a claim for refund in the sum of $2,029.75 on account of taxes illegally and erroneously assessed and collected as set forth in paragraphs VII and VIII, supra; that said claim was rejected by the Commissioner of Internal Revenue on or about September 21, 1927; that thereafter, under date of March 31, 1928, plaintiff filed with the said Collector an additional claim for refund in the sum of $206,108.26 on account of taxes illegally and erroneously assessed and collected upon the allowance

of $2,061,082.63 referred to in paragraph IV, supra; and that said claim was rejected on or about June 14, 1928.

XII

That no action has been taken upon this claim other than herein set forth before Congress or any Department of the Government or in any Court; that no person other than the plaintiff is the owner thereof or interested therein; that no assignment or transfer of this claim or any part thereof or interest therein has been made; that the plaintiff is a citizen of the United States and has at all times borne true allegiance to the Government of the United States and has not in any way voluntarily aided, abetted or given encouragement to rebellion against said Government.

XIII

That the plaintiff, The Texas & Pacific Railway Company, avers that by reason of the facts hereinbefore set out there is now justly due and owing to it by the United States, the [fol. 6] sum of $208,138.01, with interest, after allowing all just credits and off-sets.

Wherefore plaintiff prays for judgment against the United States for $208,138.01, with interest to date of payment.

The Texas & Pacific Railway Company, by J. L. Lancaster, President. Chester A. Gwinn, Humphreys & Gwinn, Attorneys for Claimant, Munsey Building, Washington, D. C.

Duly sworn to by J. L. Lancaster. Jurat omitted in printing.

[fol. 7] II. GENERAL TRAVERSE—Filed June 1, 1929

And now comes the Attorney General, on behalf of the United States, and answering the petition of the claimant herein, denies each and every allegation therein contained; and asks judgment that the petition be dismissed.

Herman J. Galloway, Assistant Attorney General.

J. H. S.

III. Argument and Submission of Case.

On February 10, 1931, this case was argued and submitted on merits by Mr. Chester A. Gwinn, for plaintiff, and by Assistant Attorney General Charles B. Rugg, for defendant.

[fol. 8] IV. **Special Findings of Fact, Conclusion of Law and Opinion of the Court by Littleton, J.**—Filed October 20, 1931.

Mr. Chester A. Gwinn for the plaintiff.

Messrs. Humphreys & Gwinn were on the brief.

Mr. Montgomery B. Angell, amicus curiæ.

Mr. Assistant Attorney General Charles B. Rugg for the defendant.

Mr. Joseph H. Sheppard was on the brief.

This suit was instituted to recover $208,138.01, income tax alleged to have been erroneously and illegally collected for 1920, with interest.

The issues are (1) whether there should be included in taxable income $2,061,082.63 paid by the United States to the plaintiff under the provisions of section 209 of the transportation act of 1920 to make good an operating deficit of plaintiff for the guaranty period; (2) whether plaintiff is required to include as income for 1920 the amount of $17,707.97 representing the cost of constructing certain spur tracks which were paid for by the person for whose benefit they were constructed; (3) whether plaintiff is entitled to deduct a contribution to the Association of Railway Executives in the amount of $4,143.28 as an ordinary and necessary business expense.

As to the first issue, plaintiff contends that since section 209 of the transportation act of 1920 was not limited to railroads that had been under Federal control nor to carriers under Federal control contract, but applied to all carriers, whether or not under Federal control and whether or not under contract, the payment of the guaranty was not for services that had been rendered, but was a bounty bestowed upon all carriers accepting the provisions of the act and was for the purpose of rehabilitating the carriers after the disruption caused by the World War conditions and of

making it possible for them to operate during the readjustment period immediately following the World War; that the guaranty payments were therefore not income within the meaning of the sixteenth amendment to the Constitution.

On the second issue plaintiff contends that the cost of constructing spur tracks, paid for by the person for whose [fol. 9] use and benefit they were constructed, is not taxable income to the corporation. And with respect to the third issue it is contended that the contribution to the Association of Railway Executives was an ordinary and necessary business expense.

Special Findings of Fact

1. Plaintiff was organized under an act of Congress approved March 3, 1871, and has its principal office at Dallas Texas. During the months of January and February, 1920, its properties were under Federal control and were operated by the Director General of Railroads, and during the remainder of the calendar year 1920 its properties were operated by a receiver under a decree of the District Court, Western District of Louisiana, Monroe division, which receivership terminated at midnight on May 14, 1924.

2. Plaintiff accepted the provisions of section 209 of the transportation act of 1920, 41 Stat. 464 and received for the "guaranty period" mentioned by that act an allowance by the Interstate Commerce Commission representing the amount necessary to make good the guaranty under section 209, supra, in the sum of $2,043,041.77, and its subsidiary, the Denison & Pacific Suburban Ry. Company, received a like allowance of $18,040.86.

3. March 15, 1921, plaintiff filed an income and profits tax return for 1920 showing a net income of $3,331,767.11 and a tax of $332,976.71, which was paid in three equal installments of $83,244.18 on March 15, September 7, and December 10, 1921, and $83,244.17 on June 4, 1921. An overpayment of $11,099.22 resulted from the above payments by reason of the failure of the carrier to apply the two rates of tax applicable to the year 1920. The overpayment mentioned was refunded to the carrier by the Director General of Railroads in his administration of section 1 of the Federal control act in connection with section 230 (h) of the revenue act of 1918.

4. Plaintiff's subsidiaries, the Weatherford Mineral Wells & Northwestern Railway Company and the Denison & Pacific Suburban Railway Company, filed their respective income and profits tax returns for 1920 on March 5 and March 15, 1921. These returns showed no tax liability, but, on the contrary, reported losses in the respective amounts of $10,114.53 and $562.23.

5. November 20, 1925, the Commissioner of Internal Revenue audited these returns and held that the plaintiff and the two other railway companies mentioned were affiliated for 1920 and consolidated them for the purpose of the determination of the tax liability. He determined a consolidated net income of $3,858,969.80 and an additional tax of $52,720.27. Among the adjustments set forth in his audit the commissioner included in taxable income the amount of $17,707.97, representing donations in that amount to the plaintiff to pay for the cost of constructing certain spur and side tracks and other improvements. The total of the said donations to plaintiff consisted of the cost of materials and labor, all of a capital nature, used in the construction of said tracks, the total of which was credited on its books to profit and loss account No. 606, "Donations."

6. Thereafter, on December 30, 1926, the commissioner made a reaudit of the returns of plaintiff and its subsidiaries for 1920 and determined a consolidated net income of $3,586,524.78 and an additional tax of $25,476.77 in lieu [fol. 10] of his determination of November 20, 1925. In this reaudit the commissioner disallowed as a deduction from gross income the amount of $2,589.55, representing a portion of a contribution paid to the Association of Railway Executives which was assessed to the plaintiff by that association of which plaintiff was, and is, a member. The total amount paid by plaintiff to the Association of Railway Executives in 1920 as its proportion of expense of maintaining and furthering the activities of that association was $4,143.28. The commissioner allowed as a deduction from gross income only $1,553.73 of this amount.

The Association of Railway Executives is a voluntary association composed of officials of all Class I railroads, with one exception, and was organized many years ago for the purpose of attending to matters of common concern to the railroads. It was believed that the principal problem

confronting the railroads just prior to the war was the impairment of their credit, due in large measure to an unsympathetic public opinion. The World War and the consequent taking over of the railroad properties by the Director General of Railroads delayed the program which the association had tentatively adopted for correcting such unfavorable public impression.

Upon the close of the war and in view of the imminent return of railroad properties to private ownership, the association resolved in 1919 to renew its plans for presenting the cause of the railroads to the public by means of a nation-wide advertising campaign. An assessment was made against each member of the road, on a mileage basis, designed to raise a fund of $1,600,000, of which $1,000,000 was estimated to be necessary for carrying on such advertising campaign. The assessment was made payable in four equal installments, two of which fell within the calendar year 1919 and two within the calendar year 1920. The ratio of $1,000,000 to $1,600,000, or 10/16ths, was the basis for the commissioner's disallowance of $2,589.55 of the contribution made by the plaintiff in 1920.

The association expended a total of $828,518.40 in connection with a series of eight advertisements inserted in newspapers covering the entire country instead of $1,000,000 as estimated. The balance of $171,481.60 was turned into the general treasury of the association. The eight advertisements purported to outline the part which had been played by the railroads in the development and progress of the Nation, the reasonableness of freight rates, the tremendous investment in railroad properties, the necessity for additional capital to enable the railroads to keep abreast of the times, comparisons of American railroads with foreign railroads, and other problems then facing the railroads, and appealed to the public for a more sympathetic understanding of such problems and for confidence and cooperation in working out their solution.

7. April 8, 1927, the Commissioner of Internal Revenue made his final determination with respect to the tax liability for 1920, in which he determined a consolidated net income of $3,639,968.48. The total tax liability as finally determined in notices mailed April 8, 1927, was allocated by the commissioner to the plaintiff and its subsidiary, the Weatherford Mineral Wells and Northwestern Railway

Company, in the amounts of $361,797.42 and $1,999.43, respectively, and, based upon said allocation, the commissioner determined a deficiency against plaintiff of $28,820.71 and a deficiency against the subsidiary of $1,999.43. [fol. 11] May 6, 1927, plaintiff paid the deficiency of $28,820.71 determined by the commissioner with respect to its tax for 1920. This deficiency constituted in part an overpayment of tax which arose as a result of the failure of the Commissioner of Internal Revenue to apply the two rates of tax applicable to the year 1920. The amount of $960.69 was refunded to the carrier by the Director General of Railroads in his administration of section 1 of the Federal control act in connection with section 230 (b) of the revenue act of 1918. The net amount of tax therefore finally paid by the carrier was $349,737.51.

8. The consolidated net income of plaintiff and its subsidiaries as finally determined by the commissioner in his notice of April 8, 1927, included as taxable income the aforementioned allowance under section 209 of the transportation act of 1920 for the "guaranty period" in the aggregate sum of $2,061,082.63, as well as the aforementioned items of donations by the public of $17,707.97 and the contribution to the Association of Railway Executives of $2,589.55.

9. On or prior to December 19, 1925, plaintiff filed with the Commissioner of Internal Revenue a waiver of the limitation within which assessment of additional taxes for 1920 might be made extending the said limitation to December 31, 1926, and on or before December 20, 1926, plaintiff filed a second waiver for extending the time for assessment of additional taxes for 1920 to December 31, 1927.

June 21, 1927, plaintiff filed a claim for refund for 1920 of $2,029.75 on account of taxes alleged to have been erroneously and illegally assessed and collected as set forth in findings 5 and 6. This claim was rejected by the commissioner September 21, 1927. Thereafter, on March 31, 1928, plaintiff filed an additional claim for refund for 1920 of $206,108.26, alleged to have been erroneously and illegally assessed and collected upon the allowance of $2,061,082.63 included in income by the commissioner as above set forth. This claim was rejected June 14, 1928.

10. Plaintiff is the sole owner of this claim. No assignment thereof has been made and no action has been taken thereon before Congress, the courts, or in any department of the Government as hereinbefore set forth.

Conclusion of Law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover $1,962.09, with interest.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of one thousand nine hundred sixty-two dollars and nine cents ($1,962.09), with interest at the rate of six per cent per annum from May 6, 1927, to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of section 177 (b) of the Judicial Code, as amended by section 615 of the revenue act of May 29, 1928.

Opinion

Littleton, Judge, delivered the opinion of the court:

On the first issue the plaintiff contends that the amount of $2,061,082.63 received from the United States under the [fol. 12] provisions of section 209 of the transportation act of 1920 to make good an operating deficit for the guaranty period was strictly a bounty or a subsidy from the sovereign to the railroad and, as such, was free from taxation by the United States. We are unable to agree with this contention. This question was before the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., 22 B. T. A. 233, wherein the board in a well-reasoned opinion reached the conclusion that such payments made by the United States under section 209 of the transportation act of 1920 constituted taxable income. We agree with the reasoning of the board and the conclusion reached in the above-mentioned case.

The plaintiff relies upon the case of Edwards v. Cuba Railroad Co., 268 U. S. 628, but we think that case is not in point. The payment made under section 209 of the transportation act was not a contribution to capital nor was it strictly and correctly a bounty or subsidy as would be

exempt from taxation. While there was no legal obligation on the part of the United States to make such payment to the railroads before section 209 of the transportation act became law, the Government was bound by legal obligation after the railroads had accepted the terms of this statute to make the necessary payments and the railroads were equally bound to pay certain excess earnings over the specified amounts to the Government. There was mutuality of arrangement and mutuality of benefit as well as of obligation. The whole matter of such payments grew out of the control and operation of most of the railroads in the country by the United States, and the purpose of the act providing for such payments was to guarantee to the railroads that for a period following the release of railroads from Federal control their operating income, of which their owners and security holders re[illegible]ved the benefit, would not be less than their average r[illegible]ay-operating income for the test period of three years prior to Federal control ending June 30, 1917. It was the railway-operating income in a specifically restricted sense which was guaranteed. The railroads, in order to receive the guaranty payments under section 209, were required to accept in writing all provisions of that section within a certain time. One of these conditions was, should the railway-operating income exceed a certain amount, the excess would be paid to the Government. This constituted a contractual agreement between the carrier and the Government, and it could not be ascertained until an accounting had been had whether the Government would pay the railroad or whether the railroad would pay the Government. This feature of the case takes away any basis for holding that the payments by the Government were pure gifts or subsidies to the railroads. Although Congress was impelled by no legal obligation in enacting this legislation requiring the Government to make these payments, it seems clear that the Government took into consideration the benefits to be derived by the people of the United States and that there were obligations of "an equitable, moral, and honorary nature" on the part of the Government existing on account of the condition of the railway systems immediately following Federal control and largely as a result thereof. United States v. Realty Co. et al., 163 U. S. 427. Such an obligation may well be said to take the place of a legal obligation to such an extent as to

take payments under section 209 of the transportation act out of the class of pure gratuities or subsidies. If the pay-
[fol. 13] ments by the Government to the railroads constitute gifts or gratuities free from tax, the question naturally arises as to the nature of payments made by the railroad to the Government where they had excess income. It would be a strained construction to say that amounts paid by the railroads to the Government where their income exceeded certain amounts were gifts by them to the Government. We think the railroads were not making voluntary contributions to the Federal Government, and certainly they did not so consider it. Nor do we consider that the Government was making gifts or voluntary contributions to the railroads where their operating income did not equal the guaranteed amount. As was well stated by the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., supra: "The payments by the Government, however, were dependent upon the operation of the railroad; that is, the use of both capital and labor. The payments were not received for the guaranty period unless the railroads were in operation during that period, and then only in the event that their operating income was less than the guaranteed amount, and we can not overlook the fact that it was railway-operating income which was guaranteed and made up. The Government derived a substantial benefit from the payments. It received consideration from the substantial good obtained for, or expected to be obtained for the people as a whole on account of the more efficient operation of the railroads and the further establishment of their credit."

For the foregoing reasons and for additional reasons fully stated and discussed by the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., supra; Missouri Pacific Railroad Co., 22 B. T. A. 267; Kansas City Southern Railway Co. and Affiliated Companies, 22 B. T. A. 949; Galveston Wharf Co., 22 B. T. A. 1312; and Chicago & North Western Railway Co., 22 B. T. A. 1407, we are of opinion that the Commissioner of Internal Revenue correctly held that the amounts received by the plaintiff from the Government under the provisions of section 209 of the transportation act constituted income for the year 1920.

The next issue concerns the question whether plaintiff was required to include in income for 1920 an amount representing the cost of constructing certain spur tracks which were paid for by the person or persons for whose benefit they were constructed. In the course of plaintiff's business as a carrier it is customary to construct spur tracks, side tracks, culverts, etc., at the request and for the benefit of persons and corporations along its right of way. The railroad furnishes the labor and materials for such construction and charges the actual cost thereof to the person for whose benefit the work was done and is reimbursed therefor by such beneficiary. To so much of such construction as is on plaintiff's right of way it acquires title and to that extent its capital account is increased. The actual cost of such improvements is, under a system of accounting prescribed by the Interstate Commerce Commission, required to be credited to profit and loss account No. 606, entitled "Donations."

We are of opinion that these transactions did not give rise to the receipt of taxable income by the plaintiff and that the defendant erroneously included in plaintiff's income for 1920 the amount of $17,707.97 on account thereof. Liberty Light & Power Co., 4 B. T. A. 155; Great Northern Railway Co., 8 B. T. A. 225.

[fol. 14] The last question is whether a payment of $4,143.28 made by plaintiff to the Association of Railway Executives, as set forth in finding 6, was an ordinary and necessary business expense allowable as a deduction from gross income for 1920. The Commissioner of Internal Revenue allowed a deduction of $1,553.73 of the total amount paid. This left a balance of $2,589.55. Plaintiff contends that this was an ordinary and necessary business expense and should be allowed as a deduction from gross income, while the defendant takes the position that the portion of the contribution disallowed falls within art. 562 of regulations 45 providing that sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income.

We are of opinion that the nature of the contribution in question and the circumstances under which it was made bring it within the field of ordinary and necessary business

expense and that it should be allowed as a deduction from gross income. Great Northern Railway Co., supra; Texas & Pacific Ry. Co., 9 B. T. A. 365; Western Maryland Ry. Co., 12 B. T. A. 889; Los Angeles & Salt Lake Railroad Co., 18 B. T. A. 168; and Norfolk & Southern Railroad Co., 22 B. T. A. 302.

Judgment will be entered in favor of plaintiff for $1,962.09 with interest thereon at 6 per cent per annum, as provided by law. It is so ordered.

Whaley, Judge; Williams, Judge; Green, Judge; and Booth, Chief Justice, concur.

[fol. 15] V. JUDGMENT OF THE COURT

At a Court of Claims held in the City of Washington on the 20th day of October, A. D., 1931, judgment was ordered to be entered as follows:

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of one thousand nine hundred sixty-two dollars and nine cents ($1,962.09), with interest at the rate of six per cent per annum from May 6, 1927, to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of section 177 (b) of the Judicial Code, as amended by section 615 of the revenue act of May 29, 1928.

VI. PROCEEDINGS HAD AFTER ENTRY OF JUDGMENT

On October 28, 1931, Chester A. Gwinn, Esq., of the firm of Humphreys & Gwinn, the attorneys of record, filed his withdrawal, leaving Adrian C. Humphreys, Esq., as the attorney of record.

[fol. 16] Clerk's certificate to foregoing transcript omitted in printing.

Endorsed on cover: File No. 36,448. Court of Claims. Term No. 634. The Texas & Pacific Railway Company, petitioner, vs. The United States. Petition for writ of certiorari and exhibit thereto. Filed January 14, 1932. File No. 36,448.

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed February 15, 1932

The petition herein for a writ of certiorari to the Court of Claims is granted, and the case is assigned for argument immediately following the hearing of case No. 560, Continental Tie and Lumber Company vs. The United States.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(1709)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 634.

THE TEXAS & PACIFIC RAILWAY COMPANY, *Petitioner*,

vs.

THE UNITED STATES, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

ADRIAN C. HUMPHREYS,
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Attorneys:

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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IN THE

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OCTOBER TERM, 1931.

No. 634.

THE TEXAS & PACIFIC RAILWAY COMPANY, *Petitioner*,

vs.

THE UNITED STATES, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

The Petitioner has filed a petition for a writ of certiorari to review a judgment of the Court of Claims.

I. Opinion of the Court Below.

The opinion of the Court of Claims was rendered on October 20, 1931, and is reported in 52 Fed. (2nd) 1040. (R. 13.)

II. Jurisdiction.

The jurisdiction of the Court is invoked under Section 3(b) of the Act of Cong. February 13, 1925, c. 229, 43 Stat. 936, 939, amending Section 240 of the Judicial Code.

The judgment of the Court of Claims was entered on October 20, 1931 (R. 17) and the petition for certiorari was filed on January 14, 1932. (R. 18.)

The case involves the taxability as "income" within the meaning of the 16th Amendment to the Constitution of a "subsidy" paid under Section 209 (c) (1) of the Transportation Act, 1920.

The following cases sustain the jurisdiction of the Court:

United States v. Ludey, 274 U. S. 295,
United States v. S. S. White Dental Mfg. Co., 274 U. S. 398,
Bonwit Teller & Co. v. United States, 283 U. S. 258.

III. Statement of the Case.

This is a suit to recover part of the income and excess profits taxes paid by Petitioner for the year 1920 under the provisions of the Revenue Act of 1918. (40 Stat. 1057.)

Petitioner is a railroad corporation and during the months of January and February, 1920, its properties were operated by the Director General of Railroads under the Federal Control Act. (40 Stat. 451.) Federal control terminated on February 29, 1920, and during the remainder of the calendar year 1920 the Petitioner was operated by a receiver under a decree of court.

Under the Federal Control Act, the Petitioner had a contract fixing the amount of just compensation during the Federal control period. The Transportation Act, 1920 (41 Stat. 456), terminated the Federal control of railroads, and carriers, under the Act were guaranteed a subsidy for the six months' period after Federal control ceased, called the "guaranty period".

Petitioner elected to take the "guaranty" provided by Section 209(c) (1) of the Transportation Act, 1920, and under this guaranty the United States paid the Petitioner and one of its subsidiaries $2,061,082.63. The Commissioner of Internal Revenue included that amount, as well as the earnings of the road, in gross income and assessed income and excess profits taxes for the year 1920 in the sum of $363,796.85. Petitioner paid the taxes of $363,796.85 and filed a claim for refund of $206,108.26 based upon the erroneous inclusion in income of the guaranty payment and a claim for $2,029.75 based upon minor items of adjustment. Upon rejection of the claims suit was filed in the Court of Claims.

The court rendered judgment for the Petitioner in the sum of $1,962.90, sustaining the Petitioner's contentions as to certain minor items, but the court held that the $2,061,082.63 paid by the United States under its guaranty was taxable income.

IV. Statutes Involved.

The Statutes involved are the Revenue Act of 1918 (Act of Cong. February 24, 1919, 40 Stat. 1057, c. 18) and Section 209(c) (1) of the Transportation Act, 1920 (Act of Cong. Feb. 28, 1920, 41 Stat. 456, 464, c. 91). Pertinent excerpts are set out in the appendix hereto.

V. Specifications of Error.

1. The Court of Claims erred in holding that the "subsidy" paid Petitioner under Section 209 of the Transportation Act, 1920, was taxable income within the meaning of the 16th Amendment to the Constitution and under the Revenue Act of 1918.

2. The Court of Claims erred in not entering judgment for the Petitioner in the sum of $201,200.07.

ARGUMENT.

The question of the taxability as "income" of subsidy payments under Section 209(c) (1) of the Transportation Act, 1920, is one of large importance to the railroads of the United States and is of wide public interest. It has never been passed upon by this Court and a decision is necessary to settle the question and the rule to be applied in other similar cases pending in the Federal Courts, before the United States Board of Tax Appeals and in the Bureau of Internal Revenue.

The question is not to be confused with payments made to the railroads as compensation for the use of its property during the Federal control period which ended February 29, 1920. Those payments are admittedly income and subject to tax.

Furthermore, Petitioner admits that the earnings of the road in 1920 are taxable income. It denies that the "subsidy" paid by the Government is "income".

1. Income Defined.

This Court in the case of *Eisner v. Macomber*, 252 U. S. 189, defined "income" within the meaning of the Sixteenth Amendment to the Constitution as follows:

"* * * 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

"* * * The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *'Derived-from-capital'*; *'the gain-derived-from-capital,'* etc." (p. 207)

The constitutional limitations upon the power of Congress to levy taxes must be strictly complied with and taxing acts are not to be extended by implication.

Eisner v. Macomber, 252 U. S. 189, 206, 211,
Nichols v. Coolidge, 274 U. S. 531, 540,
Blodgett v. Holden, 275 U. S. 142, 148,
Smietanka v. First Trust & Savings Bank, 257 U. S. 602, 605-6.

"In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

Eisner v. Macomber, 252 U. S. 189, 206.

Congress, under the 16th Amendment, has only the power to tax "income" in fact. If no income is in fact received there is no basis for the tax.

As this Court said in *Nichols v. Coolidge*, 274 U. S. 531:

> * * * "But under the mere guise of reaching something within its powers Congress may not lay a charge upon what is beyond them. Taxes are very real things and statutes imposing them are estimated by practical results." (page 541)

The "guaranty" payment under Section 209 of the Transportation Act of 1920 was not derived from capital or labor nor from the sale of its capital assets. It was a gratuity and does not come within the definition of "income".

2. The Guaranty Payment Was a Subsidy.

Payment under Section 209(c) (1) of the Transportation Act, 1920, was intended and was in fact a "subsidy" to the railroads. This is clearly shown by the debates in Congress prior to the passage of the Act where the payment was repeatedly referred to as a "gratuity", "subsidy" or "gift".

> Congressional Record, Vol. 58, Part 8, pp. 8342, 8355, 8448, 8453, 8454, 8458, 8466,—Part 9, pp. 8454, 8675, 8680, 9189.
> Congressional Record, Vol. 59, Part 4, pp. 3289, 3313, 3343, 8680.

As typical we quote Representative Kitchen (Congressional Record, Vol. 59, Part 4, p. 3313).

> "In my judgment, and I make the prediction, that it will require practically the entire amount

of the standard return for the six months, that is, $475,000,000, to make good the guaranty.

"Whatever the amounts shall be, it is an absolute gift by the Government to the railroads—the deliberate taking out of the pockets of the taxpayers and giving it to the railroad owners."

Representative Sims (Cong. Rec. Vol. 59, Part 4, p. 3289):

"But not satisfied with this burden upon the people, we give a subsidy for the first six months."

And again he declares (Cong. Rec. Vol. 58, Part 9, p. 8680):

"This House has just voted to guarantee the standard rental return to all railroads making application for increase of rates within a given time, which amounts to nobody knows how many million dollars, an absolute subsidy, an absolute gift."

Representative Steagall (Cong. Rec. Vol. 58, Part 9, p. 8675):

"They (the people) are going to be sorely disappointed when they learn that this bill looks to an increase of these burdens along with its enormous subsidy to the roads."

The guaranty payments were neither derived from capital, nor from labor, nor from both combined. They were not derived from the sale or conversion of capital assets. They were not derived from services rendered. They were not derived from any contract which either the carriers or the Government

entered into as a business transaction for profit. They were Government aids or subsidies to protect the public and insure an efficient transportation system during the six months' period following Federal Control.

The general purposes of payments under section 209 were stated by this Court in *United States v. Guaranty Trust Co.*, 280 U. S. 478, as follows:

> "* * * Congress deemed it important to preserve for the nation substantially the whole existing transportation system * * *. In order to accomplish this, it was thought necessary that the United States should, to a certain extent, finance the carriers until it would become possible to restore their credit, by increase of rates or otherwise. The provisions of Title II of Transportation Act, 1920, were framed to that end." (pp. 484-485)

See also Akron C. & Y. Co. v. U. S., 261 U. S. 184, 190.

3. A Subsidy Is Not Taxable as "Income."

This case is controlled by the decision of this Court in *Edwards v. Cuba R. R. Co.*, 268 U. S. 628, holding that subsidies paid to a railroad by the Cuban Government were not taxable as "income" within the 16th Amendment to the Constitution. In that case the Cuban Government granted subsidies to a New Jersey railroad corporation based on the number of miles of line constructed. To receive the subsidies the railroad company had to comply with definite requirements, namely, a 1/3 reduction in rates for employees and troops of the Government, special trains and rates in case of war, a reduction in first class rates and the carrying of public correspondence free. The primary

requirement was of course to construct the railroad and the purpose of the subsidy was construction and operation in the interests of the Cuban people. This Court said:

> * * * "The Cuban laws and contracts are similar to legislation and arrangements for the promotion of railroad construction which have been well known in the United States for more than half a century. Such aids, gifts and grants from the government, subordinate political subdivisions or private sources,—whether of land, other property, credit or money,—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities. * * * The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. * * * The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment. See *Stratton's Independence v. Howbert*, 231 U. S. 399, 415; *Eisner v. Macomber*, 252 U. S. 189, 207; *Merchants' Loan & Trust Co. v. Smietanka, supra.*" (Pages 632-633.)

Furthermore, the value of property acquired by gift is excluded from gross income by section 213(b) (3) of the Revenue Act of 1918 (40 Stat. 1057, 1065).

4. There Was No Consideration or Legal Obligation for the Guaranty Payment.

The language used in section 209 of the Transportation Act is important. It states "The United States hereby guarantees". The statute provides "a guaranty" and refers to "the guaranty period".

The payment to Petitioner did not arise from any legal obligation on the part of the Government growing out of Federal Control. The Federal Control Act as supplemented by Sections 202 and 203 of the Transportation Act provided full compensation. Moreover Section 209 by its terms (c) (4) applied to carriers that had not been under Federal Control.

The Petitioner was not required to do anything in order to be entitled to the payment other than to operate its road during the six months' period after Federal Control ended on February 29, 1920.

The subsidy payment was in no sense for services rendered or to be rendered by the Petitioner. It was not profits or gains derived from the use or operation of the railroad.

> Birmingham Trust and Savings Co. v. Atlanta, etc., Ry. Co., 300 Fed. 173, 179.

In the *Cuba Railroad case* (*supra*), the railroad had to build and operate the railroad, agree to lower rates, etc. But this contractual obligation by the railroad was not held to render the payments "income". In this respect the instant case is even stronger than the *Cuba case* for here is an absence of conditions.

In Finance Docket No. 1176, 70 I. C. C. 115, 116, the Interstate Commerce Commission, having under consideration the provisions of Section 209 of the Transportation Act of 1920, said:

> "The guaranty under section 209 is wholly independent of any damages which the carriers may have suffered by reason of the temporary taking of their property during the period of Federal control. For all such damages the government must render just compensation; and by their acceptance of the provisions of section 209 the car-

riers have in no way surrendered or abated any claims arising out of Federal operation. The guaranty, therefore, *was not founded upon a legal obligation,* but upon the thought that in fairness it was the duty of the government to protect the income of the carriers, following the termination of Federal control, until such time as higher rates could be made effective under the provisions of section 15a of the interstate commerce act." (Italics ours.)

The guaranty payment lacked every characteristic which this Court has held must exist before there is "income" subject to tax. It was not "income" from "operation".

As to the general purposes of such subsidies in the *Cuba Railroad case* this Court said that they were given in order to "induce the construction and operation of railroads for the service of the public". The condition imposed was to "operate" as well as to construct. The nature of the payment cannot be determined by the use to which the payment is applied. Taxability does not depend upon whether the payment was used for capital additions or current expenses. If in its nature the payment is not income, it cannot be made income by the use to which it is put. In fact the payment was a pure Government aid or subsidy.

CONCLUSION.

The importance of the question involved warrants the granting of the petition and the allowance of the writ.

ADRIAN C. HUMPHREYS,
NEWTON K. FOX,
Attorneys.

APPENDIX.

Excerpts from the Revenue Act of 1918.
(40 Stat. 1057, c. 18)

Section 213. (40 Stat. 1065)

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * * * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);"

Section 233. (40 Stat. 1077)

"Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in section 213, * * *"

Excerpts from the Transportation Act, 1920.
(41 Stat. 456, 464-467, c. 91)

Guaranty to Carriers After Termination of Federal Control.

"Sec. 209. (a) When used in this section—

The term 'carrier' means (1) a carrier by railroad or partly by railroad and partly by water, whose railroad or system of transportation is under Federal control at the time Federal control terminates, or which has heretofore engaged as a common carrier in general transportation and competed for traffic, or connected, with a railroad at any time under Federal control; and (2) a sleeping car company whose system of transportation is under Federal control at the time Federal control terminates; * * *

The term 'guaranty period' means the six months beginning March 1, 1920.

The term 'test period' means the three years ending June 30, 1917; and

The term 'railway operating income' and other references to accounts of carriers by railroad shall, in the case of a sleeping car company, be construed as indicating the appropriate corresponding accounts in the accounting system prescribed by the Commission.

(b) This section shall not be applicable to any carrier which does not on or before March 15, 1920, file with the Commission a written statement that it accepts all the provisions of this section.

(c) The United States hereby guarantees—

(1) With respect to any carrier with which a contract (exclusive of so-called cooperative contracts or waivers) has been made fixing the amount of just compensation under the Federal Control Act, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half the amount named in such contract as annual compensation, or, where the contract fixed a lump sum as compensation for the whole period of Federal operation, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than an amount which shall bear the same proportion to the lump sum so fixed as six months bears to the number of months during which such carrier was under Federal operation, including in both cases the increases in such compensation provided for in section 4 of the Federal Control Act;

* * * * * * * * *

(d) If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (1), (2), or (4) of subdivision (c) is in excess of the minimum railway operating income guaranteed in such paragraph, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. * * * Notwithstanding the provisions of this subdivision, any carrier may retain out of any such excess any amount necessary to enable it to pay its fixed charges accruing during the guaranty period.

* * * * * * * * *

(g) The Commission shall, as soon as practicable after the expiration of the guaranty period, ascertain and certify to the Secretary of the Treasury the several amounts necessary to make good the foregoing guaranty to each carrier. The Secretary of the Treasury is hereby authorized and directed thereupon to draw warrants in favor of each such carrier upon the Treasury of the United States, for the amount shown

in such certificate as necessary to make good such guaranty. An amount sufficient to pay such warrants is hereby appropriated out of any money in the Treasury not otherwise appropriated.

(h) Upon application of any carrier to the Commission, asking that during the guaranty period there may be advanced to it from time to time such sums, not in excess of the estimated amount necessary to make good the guaranty, as are necessary to enable it to meet its fixed charges and operating expenses, the Commission may certify to the Secretary of the Treasury the amount of, and times at which, such advances, if any, shall be made. The Secretary of the Treasury, on receipt of such certificate, is authorized and directed to make the advances in the amounts and at the times specified in the certificate, upon the execution by the carrier of a contract, secured in such manner as the Secretary may determine, that upon final determination of the amount of the guaranty provided for by this section such carrier will repay to the United States any amounts which it has received from such advances in excess of the guaranty, with interest at the rate of 6 per centum per annum from the time such excess was paid. There is hereby appropriated, out of any money in the Treasury not otherwise appropriated, a sum sufficient to enable the Secretary of the Treasury to make the advances referred to in this subdivision."

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OCTOBER TERM, 1931.

No. 634.

THE TEXAS & PACIFIC RAILWAY COMPANY,
Petitioner,

vs.

UNITED STATES.

BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

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THE TEXAS & PACIFIC RAILWAY COMPANY,
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UNITED STATES.

BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

On writ of certiorari to the United States Court of Claims to review a judgment in an action for the refund of Federal income and excess profits taxes.

Opinion of the Court Below.

The opinion of the Court of Claims is reported in 52 Fed. (2d) 1040 (R. 13).

Jurisdiction.

The jurisdiction of the Court is invoked under Section 3(b) of the Act of Cong. February 13, 1925, c. 229, 43 Stat. 936, 939, amending Section 240 of the Judicial Code.

A petition for a writ of certiorari was filed on January 14, 1932 (R. 18) and was granted February 15, 1932 (R. 19).

Statement of the Case.

This is a suit to recover $208,138.01, part of the income and excess profits taxes paid by Petitioner for the year 1920 under the provisions of the Revenue Act of 1918 (Act of Cong. Feb. 24, 1919, c. 18), 40 Stat. 1057 (R. 8).

Petitioner is a railroad corporation and during the months of January and February, 1920, its properties were operated by the Director General of Railroads under the Federal Control Act (Act of Cong. Mar. 21, 1918, c. 25), 40 Stat. 451 (R. 9).

Federal Control terminated on February 29, 1920, under the provisions of the Transportation Act, 1920 (Act of Cong. Feb. 28, 1920, c. 91), 41 Stat. 456, and, during the remainder of the calendar year 1920, the Petitioner was operated by a receiver under a decree of court (R. 9).

Petitioner accepted the provisions of Section 209 of the Transportation Act, 1920, and under the "guaranty" received for the period of six months after Federal Control ceased, called the "guaranty period", the sum of $2,043,041.77, and one of its two subsidiaries received $18,040.86, a total of $2,061,082.63 (R. 9).

For the year 1920 Petitioner filed its tax return and reported thereon and paid a tax of $332,976.71 (R. 9). Petitioner's two subsidiaries filed separate tax returns and reported losses (R. 10).

The Commissioner of Internal Revenue upon audit and reaudits of the 1920 returns in 1925, 1926 and 1927, consolidated the Petitioner and its subsidiaries (R. 10-11), made various adjustments to income and finally, in April 1927, determined a consolidated net income of $3,639,968.48 (R. 11), and a tax liability of Petitioner and its subsidiaries of $363,796.85, which was allocated $361,797.42 to the Petitioner and $1,999.43 to one of its subsidiaries (R. 12). The resulting deficiency in tax of the Petitioner of $28,820.71 was duly paid (R. 12). The total net tax paid by Petitioner after reimbursement made by the Director General of Railroads was $349,737.51 (R. 12).

The Commissioner of Internal Revenue in determining the consolidated net income of Petitioner and its subsidiaries for the year 1920 included as income the "guaranty" payment of $2,061,082.63 made under Section 209(c)(1) of the Transportation Act, 1920 (R. 12).

Thereafter the Petitioner duly filed a claim for refund of $206,108.26 based upon the erroneous inclusion in income of the "guaranty" payment and a claim for $2,029.75 based upon certain minor items (R. 12).

The Commissioner of Internal Revenue rejected the claims for refund (R. 12) and this suit was brought within two years from the date of rejection (R. 3).

The Court of Claims gave judgment for the Petitioner for $1,962.09 (R. 13), sustaining the Petitioner's contentions as to the minor items. The Court held, however, that the "guaranty" payment of $2,061,082.63 was "income" subject to tax (R. 15).

Statutes Involved.

The Statutes involved are the Revenue Act of 1918 (Act of Cong. February 24, 1919, c. 18), 40 Stat. 1057, and Section 209(c)(1) of the Transportation Act, 1920 (Act of Cong. Feb. 28, 1920, c. 91), 41 Stat. 456, 464-467. Pertinent excerpts from these Acts are set out in the Appendix hereto.

Question Involved.

Was the "guaranty" payment under Section 209(c)(1) of the Transportation Act, 1920, a "subsidy" or taxable as "income" under the Revenue Act of 1918 and the Sixteenth Amendment to the Constitution?

Specification of Errors.

1. The Court of Claims erred in holding that the "guaranty" payment to Petitioner under Section 209 of the Transportation Act, 1920, was "income" taxable under the Revenue Act of 1918 and the Sixteenth Amendment to the Constitution.

2. The Court of Claims erred in not entering judgment for Petitioner in the sum of $201,200.07, the amount of taxes overpaid for 1920 on excluding the "guaranty" payment from "income".

Summary of Argument.

I. The condition of the railroads at the termination of Federal control was such that rehabilitation was necessary to insure an adequate transportation system. The purpose of the Transportation Act, 1920, was to remedy this situation. *United States* v. *Guaranty Trust Co.*, 280 U. S. 478.

Congress recognized the immediate need of the railroads for additional "capital". Without any legal obligation on the part of the Government, the Transportation Act was passed providing for a "guaranty" payment.

The "guaranty" payment was not income from operation of the railroad. *Birmingham Trust & Savings Co.* v. *Atlanta etc. Ry. Co.*, 300 Fed. 173. The payment was in fact and was intended by Congress as a subsidy.

II. Being a subsidy the "guaranty" payment is not income within the meaning of the Sixteenth Amendment. *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628. Every economic advantage or receipt of money does not result in "income". Mutuality and consideration did not remove the "guaranty" payment from the category of a subsidy or convert it into "income". *Edwards* v. *Cuba Railroad Co., supra; United States* v. *Supplee-Biddle Hardware Co.*, 265 U. S. 189; *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170. The provision for payment by the railroads to the Government of any excess over the "guaranty" was a limitation or condition to eliminate carriers not in need of the subsidy. It was not inserted as a money producing provision for the Government. It was designed primarily as an administrative measure to eliminate applications by carriers not in need of financial assistance and to save auditing expenses and delay.

The nature of the "guaranty" payment, and not the manner in which it might be spent, determines whether it is "income". *United States* v. *Merriam*, 263 U. S. 179. The "guaranty" payment was not derived from capital or labor, or from both combined. It was not "income" within the definition which this Court has adopted and consistently followed, *Eisner* v. *Macomber*, 252 U. S. 189, as a limitation upon the power of Congress under the Sixteenth Amendment.

ARGUMENT.

Preliminary Statement.

The question of the taxability as "income" of the payment under Section 209(c)(1) of the Transportation Act, 1920, is not to be confused with payments made to carriers under the Federal Control Act as compensation for the use by the Government of railroad properties during Federal Control. The Transportation Act terminated Federal Control on February 29, 1920.

Payments under the Federal Control Act are admittedly "income" and subject to tax. Taxes based on those payments and on earnings of Petitioner from operation of its road in 1920 are *not* sought to be recovered in this action.

This case involves a "guaranty" payment under the Transportation Act, 1920, for the period of six months, March 1, 1920, to August 31, 1920, called "the guaranty period", after possession and use by the Government had ended and the properties had been returned to private ownership.

Section 209 provides for a "guaranty" payment by the Government under various conditions prescribed therein. This case falls under Section 209(c)(1) as the Petitioner had a contract fixing just compensation for the Federal Control period. In this case the amount of the "guaranty" payment is the excess of one-half of the annual amount fixed as "just compensation" in the Federal Control contract over "railway operating income."

"Railway operating income" (a term defined by the Interstate Commerce Commission in its Regulations, "Issue of 1914", governing the "Classification of Income, Profit and Loss for Steam Roads") is an amount determined by deducting from "railway operating revenues", the items of "railway operating expenses", "railway tax accruals", and "uncollectible railway revenues."

I.

The "Guaranty" Payment Under the Transportation Act, 1920, Was a Government Subsidy Designed to Insure An Adequate Transportation System for the Country.

1. The situation of the railroads at the end of Federal control and the purpose of the Transportation Act, 1920.

Government operation of railroads during the war years had resulted in a critical situation and the maintenance of a transportation system for the United States was at stake. Tracks, structures and rolling stock had deteriorated. Additions and betterments were imperative. Funds were needed for improvements, expansion and additional equipment. The railroads had to be rehabilitated from the standpoint of "capital."

The condition of the railroads when the Transportation Act, 1920, was passed and the purpose to preserve for the nation the whole existing transportation system was stated by this Court in *United States* v. *Guaranty Trust Co.*, 280 U. S. 478, as follows:

> "These appropriations were made in order to meet a pressing need. At the time of the passage of Transportation Act, 1920, most of the railroads of the United States lacked funds for necessary improvements, equipment, and expansion of facilities. Some of the carriers needed funds, also, to meet maturing obligations. The credit of

> many carriers was seriously impaired. There was a general reluctance among investors to purchase new railroad securities even of the strongest railroads. Congress deemed it important to preserve for the nation substantially the whole existing transportation system. Compare *New England Divisions Case*, 261 U. S. 184, 190". (p. 484).

The same purpose was expressed by Congress.

Senator Cummins, Chairman of the Interstate Commerce Committee of the Senate, said (Cong. Rec., Vol. 59, Part 4, p. 3327):

> "Without entering into the details of the situation it is well known to every observer that we need from 100,000 to 200,000 additional cars, we need more main tracks, more side tracks, more warehouses, and more terminal facilities of all kinds. If the railways are to succeed in giving to the people what they must have, if we are to prosper, these companies must borrow or secure in some way not less than $600,000,000 this year and $1,000,000,000 next year."

Representative Cooper, a member of the Interstate Commerce Committee of the House, said (Cong. Rec., Vol. 59, Part 4, p. 3308):

> "* * * It is estimated that about 200,000 new cars must be built in 1920 to make good the deficiency.
>
> It is also stated that the normal railroad requirements are about 3,000 new locomotives per year, yet during Federal control only 2,000 locomotives, or one-third of the normal requirement has been provided. Only 923 new passenger cars have been purchased in over two years and only 721 miles of railroad extension have been built."

Representative Barkley, a member of the Interstate Commerce Committee of the House, said (Cong. Rec., Vol. 58, Part 8, p. 8445):

> "Therefore as a matter of fact if we do not help them to finance at this time these capital investments they

> will have to go into the markets at the present high rate of money and finance them themselves. And the inability to do so is going to put many of the railroads into the hands of receivers."

Representative Barkley (Cong. Rec., Vol. 58, Part 8, p. 8331):

> "I think it is not going too far to say that if we on the 31st of December were to turn the roads back to their owners without remedial legislation, it would result in the most disastrous financial panic that the country has ever seen."

2. There was no legal obligation on the Government to make the "guaranty".

The "guaranty" payment to Petitioner did not arise from any legal obligation on the part of the Government.

See: *Finance Docket No. 1176,* 70 I. C. C. 115, 116.

Compares: *Eastern Extension, etc. Tel. Co. Ltd.* v. *United States,* 251 U. S. 355, 363-364.

The Federal Control Act provided for the settlement of all matters growing out of the Federal control period. The Transportation Act did not apply to that period or to settlements based on use of the properties by the Government during Federal Control.

Furthermore, it should be noted that Section 209, by Subdivision (c)(4), makes the Act equally applicable to carriers that had not been under Federal control.

The Court of Claims in its opinion admits that there was "no legal obligation in enacting this legislation requiring the Government to make these payments," but says "that there were obligations of 'an equitable, moral, and honorary nature'" which "may well be said to take the place of a legal obligation."

3. The "guaranty" payment was not income from operation of the railroads but was a subsidy.

The "guaranty" payment was not derived from services rendered or to be rendered by the Petitioner to the United States. It was not compensation for use of the railroad properties by the Government which ended March 1, 1920. It was not a profit or gain derived from the use or operation of the railroad by the Petitioner.

> "The guaranty money was not produced by railroad operation."
>
> *Birmingham Trust and Savings Co.* v. *Atlanta, etc., Ry. Co.*, 300 Fed. 173, 179.

Petitioner's earnings from operation of its railroad in 1920 have been included in taxable income and the tax paid thereon is not contested in this suit.

While "railway operating income" on the one hand, and one-half of the annual amount of "just compensation" specified in the Federal Control contract on the other hand, are used in this case as the basis for computing the amount of the "guaranty" payment, the subsidy itself is the result of comparing those factors.

The "guaranty" payment is neither "railway operating income" nor "just compensation" as those terms are used only as a measure to determine, first, qualification for receiving the subsidy, and, second, the amount of the subsidy. Used as a yardstick or measure they do not characterize the "guaranty" payment as either "operating income" or "just compensation". The terms are used in the same capacity as "income" was used as a measure for the Corporation Excise Tax levied by the Act of August 5, 1909, c. 6, 36 Stat. 113. Although income was there used as the measure, this Court held that the Act levied an "Excise" and not an "income" tax.

> *Flint* v. *Stone Tracy Co.*, 220 U. S. 107;
> *Stratton's Independence Ltd.* v. *Howbert*, 231 U. S. 399.

While section 209(d) provides that any excess of "railway operating income" over one-half the amount named in the Federal Control contract must be paid into the Treasury there was no excess in this case.

To say that "operating income" was guaranteed is not only erroneous but begs the question of the fundamental nature of the payment. Was it "income" or a "subsidy" as intended by Congress?

The particular language used in section 209 of the Transportation Act, 1920, is of importance. It states "The United States hereby guarantees", it provides a "guaranty" and refers to "the guaranty period".

Payments under Section 209 of the Transportation Act, 1920 were referred to by members of Congress as a "subsidy" or "gift".

As typical we quote Representative Kitchen (Cong. Rec., Vol. 59, Part 4, p. 3313):

> "In my judgment, and I make the prediction that it will require practically the entire amount of the standard return for the six months, that is, $475,000,000, to make good the guaranty.
>
> Whatever the amount shall be, it is an absolute gift by the Government to the railroads—the deliberate taking out of the pockets of the taxpayers and giving it to the railroad owners."

Representative Sims, a member of the Interstate Commerce Committee of the House (Cong. Rec., Vol. 59, Part 4, p. 3289):

> "But not satisfied with this burden upon the people, we give a subsidy for the first six months."

Representative Steagall (Cong. Rec., Vol. 58, Part 9, p. 8675):

> "They (the people) are going to be sorely disappointed when they learn that this bill looks to an increase of these burdens along with its enormous subsidy to the roads."

Representative Box (Cong. Rec., Vol. 58, Part 9, p. 9189):

> "The amount which this will cost the Government, in guaranties and subsidies, will run into hundreds of millions, which, in addition to the sums loaned to the roads, will be taken from the public treasury at a time when the Government is already paying out from one to four billion dollars more per year than it is receiving in taxes and revenues, and will greatly increase the already heavy deficits."

The "guaranty" payment was not received for services rendered to the United States. The payment was not derived from capital. It was a Government subsidy or aid, so intended by Congress, with the view of protecting and insuring an efficient system of transportation for the people.

II.

Being a Subsidy, the "Guaranty" Payment Is Not "Income" Within the Meaning of the Sixteenth Amendment.

1. A Subsidy Is Not Taxable as "Income".

This case is controlled by the decision of this Court in *Edwards* v. *Cuba R. R. Co.*, 268 U. S. 628, holding that subsidies paid to a railroad by the Cuban Government were not taxable as "income" under the Sixteenth Amendment to the Constitution. In that case the Cuban Government granted subsidies to a New Jersey railroad corporation based on the number of miles of line constructed. To receive the subsidies the railroad company had to comply with certain definite requirements, and by executed contracts the company agreed to a one-third reduction in rates for transportation of employees and troops of the Government, to reduce first class rates, to carry public correspondence free, to carry small produce for one-half the tariff, to allow the Government to

establish telegraph and telephone stations along the railroad and to transport troops in special trains at special rates in case of war.

Under these circumstances, this Court said:

> • • • "The Cuban laws and contracts are similar to legislation and arrangements for the promotion of railroad construction which have been well known in the United States for more than half a century. Such aids, gifts and grants from the government, subordinate political subdivisions or private sources,—whether of land, other property, credit or money,—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities. *Burke* v. *Southern Pacific R. R. Co.*, 234 U. S. 669, 679; *Louisville & Nashville R. R.* v. *United States*, 267 U. S. 395. Usually they are given to promote settlement and to provide for the development of the resources in the territory to be served. The things so sought to be attained in the public interest are numerous and varied. • • • The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. • • • The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment. See *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Eisner* v. *Macomber*, 252 U. S. 189, 207; *Merchants' Loan & Trust Co.* v. *Smietanka, supra.*" (pp. 632-633).

2. Mutuality and consideration for the agreement to pay the "guaranty" does not make the payment taxable as "income".

In this respect the instant case is even stronger than the *Cuba Railroad Case* (*supra*). In the *Cuba Case* the company agreed, by executed contracts, to reduce existing rates one-third for carrying Government troops and employees, to carry Government mails free, to reduce rates for first-class passengers, to carry small produce for one-half the tariff, to allow the Government to establish telegraph and tele-

phone stations along the railroad and in case of war to transport troops in special trains at special rates.

All these were conditions attached to receiving the subsidy and were considerations for its payment. There was real consideration and mutuality of obligation. Even under these conditions this Court held that the considerations and the mutual and contractual obligations of the railroad and the Government did not render the payments "income".

Every valid contract must rest upon consideration, but consideration as such does not necessarily make the amount received under the contract "income" within the definition of this Court. Consideration for a contract cannot alone create "income". Every economic advantage or receipt of money does not result in "income". This Court has so held in the case of proceeds of insurance on the life of an officer (*United States* v. *Supplee-Biddle Hardware Co.*, 265 U. S. 189), the extinguishment of a debt for less than its face (*Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170), and a subsidy payment (*Cuba Railroad Case, supra*). In those cases the amounts were received under contracts based upon real consideration and mutuality of obligation.

Also the receipt of a stock dividend (*Eisner* v. *Macomber*, 252 U. S. 189), and a stock right (*Miles* v. *Safe Deposit Co.*, 259 U. S. 247), were held not to be "income". Furthermore, a bequest to an executor in lieu of compensation (*United States* v. *Merriam*, 263 U. S. 179), and a gift (*Blodgett* v. *Holden*, 275 U. S. 142), have been held not to be taxable "income".

That the petitioner assented to the provisions of the Transportation Act and agreed, on the remote condition of excess earnings, to pay such excess to the Government cannot alter or affect the question of whether the subsidy paid was, in fact, "income".

The purpose of Section 209 was to give Governmental aid to those carriers which needed rehabilitation, and thus to insure transportation facilities to the country at large. Such aid to be effective would have to be prompt. With this pur-

pose in mind it was necessary to exclude carriers which were not in need of aid. The provision that a qualifying carrier realizing an excess during the guaranty period must pay such excess into the Treasury was a limitation or condition that effectively eliminated from the subsidy carriers which did not need it. The condition likewise relieved the Interstate Commerce Commission of an enormous auditing and expense burden. The provision as to excess earnings was really a condition limiting payment to only those carriers in need. It would be absurd to consider the condition as a money producing provision. It was recognized from the outset that the Government would receive little or nothing under the provision, but on the other hand would be compelled to pay the subsidies.

3. The way in which the "guaranty" payment might be spent does not determine its status as "income".

The nature or character of the "guaranty" payment cannot be determined from its use. Taxability as "income" does not depend upon how the money received is spent, whether for capital additions, current expenses or what not. If in its nature the "guaranty" is not "income" within the definition of this Court, the use to which it is put cannot convert it into "income".

Compare: *United States* v. *Merriam*, 263 U. S. 179.

While there was no restriction on how the "guaranty" payment was spent, the railroads urgently needed "capital" for cars, tracks, terminal facilities, buildings, capital improvements, additions and betterments and the purpose of the Act was to meet that need.

See: *United States* v. *Guaranty Trust Co.* (*supra*, p. 6);
Statement of Senator Cummins (*supra*, p. 7);
Statement of Representative Cooper (*supra*, p. 7).

4. Income Defined.

This Court in the case of *Eisner* v. *Macomber*, 252 U. S. 189, defined "income", within the meaning of the Sixteenth Amendment to the Constitution, as follows:

> "* * * 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle Case* (pp. 183, 185)."
>
> "* * * The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *'Derived-from-capital';*—'the *gain-derived-from-capital,*' etc." (p. 207).

In the case of *Merchants' Loan & Trust Co., Trustee* v. *Smietanka*, 255 U. S. 509, the above definition was followed (pp. 517-518) without modification or change, this Court being "entirely satisfied" with the completeness of the definition.

The definition of income in the *Macomber Case* was not casual or used by way of illustration. It represents an all-inclusive rule established for future use in determining what is "income". The Court after defining income then considered whether a stock dividend fell within its terms. This established definition has been consistently used in deciding all subsequent cases involving the question of what is "income".

As to the constitutional limitation upon Congress and the distinction between what is and what is not "income" this Court said in the *Macomber Case*, at page 206:

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essen-

> tial to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

The constitutional limitation upon the power of Congress to levy taxes must be strictly complied with.

> *Eisner* v. *Macomber*, 252 U. S. 189, 206, 211;
> *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602, 605-606;
> *Blodgett* v. *Holden*, 275 U. S. 142, 148.

Congress, under the Sixteenth Amendment, has only the power to tax "income" in fact. If no income is in fact received there is no basis for the tax.

The "guaranty" payment under Section 209 of the Transportation Act, 1920, was not "derived" from "capital or labor" nor from "a sale or conversion of capital assets." It was not "income" under the definition of this Court.

CONCLUSION.

The "guaranty" payment lacks every characteristic necessary to constitute "income" as this Court has defined that term. The Court of Claims was in error in holding that the payment was "income" subject to taxation.

The judgment below should be modified accordingly.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1918.

(40 Stat. 1057)

SECTION 213. (40 Stat. 1065.)

"SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);"

SECTION 233. (40 Stat. 1077.)

"SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in section 213 * * *" with certain enumerated exceptions which are here immaterial.

Transportation Act of 1920.

SECTION 209. (41 Stat. 456, 464-467.)

GUARANTY TO CARRIERS AFTER TERMINATION OF FEDERAL CONTROL.

"SEC. 209. (a) When used in this section—

The term 'carrier' means (1) a carrier by railroad or partly by railroad and partly by water, whose railroad or system of transportation is under Federal control at the time Federal control terminates, or which has heretofore engaged as a common carrier in general transportation and competed for traffic, or connected, with a railroad at any time under Federal control; and (2) a sleeping car company whose system of transportation is under Federal control at the time Federal control terminates; but does not include a street or interurban electric railway not under Federal control at the time Federal control terminates, which has as its principal source of operating revenue urban, suburban, or interurban passenger traffic or sale of power, heat, and light, or both;

The term 'guaranty period' means the six months beginning March 1, 1920.

The term 'test period' means the three years ending June 30, 1917; and

The term 'railway operating income' and other references to accounts of carriers by railroad shall, in the case of a sleeping car company, be construed as indicating the appropriate corresponding accounts in the accounting system prescribed by the Commission.

(b) This section shall not be applicable to any carrier which does not on or before March 15, 1920, file with the Commission a written statement that it accepts all the provisions of this section.

(c) The United States hereby guarantees—

(1) With respect to any carrier with which a contract (exclusive of so-called cooperative contracts or waivers) has been made fixing the amount of just compensation under the Federal Control Act, that the railway operating income of

such carrier for the guaranty period as a whole shall not be less than one-half the amount named in such contract as annual compensation, or, where the contract fixed a lump sum as compensation for the whole period of Federal operation, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than an amount which shall bear the same proportion to the lump sum so fixed as six months bears to the number of months during which such carrier was under Federal operation, including in both cases the increases in such compensation provided for in section 4 of the Federal Control Act;

(2) With respect to any carrier entitled to just compensation under the Federal Control Act, with which such a contract has not been made, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half of the annual amount estimated by the President as just compensation for such carrier under the Federal Control Act, including the increases in such compensation provided for in section 4 of the Federal Control Act. If any such carrier does not accept the President's estimate respecting its just compensation, and if in proceedings under section 3 of the Federal Control Act it is determined that a larger or smaller annual amount is due as just compensation, the guaranty under this paragraph shall be increased or decreased accordingly;

(3) With respect to any carrier, whether or not entitled to just compensation under the Federal Control Act, with which such a contract has not been made, and for which no estimate of just compensation is made by the President, and which for the test period as a whole sustained a deficit in railway operating income, the guaranty shall be a sum equal to (a) the amount by which any deficit in its railway operating income for the guaranty period as a whole exceeds one-half of its average annual deficit in railway operating income for the test period, plus (b) an amount equal to one-half the annual sum fixed by the President under section 4 of the Federal Control Act;

(4) With respect to any carrier not entitled to just compensation under the Federal Control Act, which for the test period as a whole had an average annual railway operating income, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half

the average annual railway operating income of such carrier during the test period.

(d) If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (1), (2) or (4) of subdivision (c) is in excess of the minimum railway operating income guaranteed in such paragraph, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (3) of subdivision (c) is in excess of one-half of the annual sum fixed by the President with respect to such carrier under section 4 of the Federal Control Act, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. The amounts so paid into the Treasury of the United States shall be added to the funds made available under section 202 for the purposes indicated in such section. Notwithstanding the provisions of this subdivision, any carrier may retain out of any such excess any amount necessary to enable it to pay its fixed charges accruing during the guaranty period.

(e) For the purposes of this section railway operating income, or any deficit therein, for the test period shall be computed in the manner provided for in section 1 of the Federal Control Act.

(f) In computing railway operating income, or any deficit therein, for the guaranty period for the purposes of this section—

(1) Debits and credits arising from the accounts, called in the monthly reportly to the Commission equipment rents and joint facility rents, shall be included, but debits and credits arising from the operation of such street electric passenger railways, including railways commonly called interurbans, as are not under Federal control at the time of termination thereof, shall be excluded;

(2) Proper adjustments shall be made (a) in case any lines which were, during any portion of the period of Federal control, a part of the railroad or system of transportation of the carrier, and whose railway operating income was included in such income of the carrier for the test period, do not continue to be a part of such railroad or system of transporta-

tion during the entire guaranty period, and (b) in case of any lines acquired by, leased to, or consolidated with, the railroad or system of transportation of the carrier at any time since the end of the test period and prior to the expiration of the guaranty period, for which separate operating returns to the Commission are not made in respect to the entire portion of the guaranty period;

(3) There shall not be included in operating expenses, for maintenance of way and structures, or for maintenance of equipment, more than an amount fixed by the Commission. In fixing such amount the Commission shall so far as practicable apply the rule set forth in the proviso in paragraph (a) of section 5 of the "standard contract" between the United States and the carriers (whether or not such contract has been entered into with the carrier whose railway operating income is being computed);

(4) There shall not be included any taxes paid under Title I or II of the Revenue Act of 1917, or such portion of the taxes paid under Title II or III of the Revenue Act of 1918 as by the terms of such Act are to be treated as levied by an Act in amendment of Title I or II of the Revenue Act of 1917; and

(5) The Commission shall require the elimination and restatement of the operating expenses and revenues (other than for maintenance of way and structures, or maintenance of equipment) for the guaranty period, to the extent necessary to correct and exclude any disproportionate or unreasonable charge to such expenses or revenues for such period, or any charge to such expenses or revenues for such period which under a proper system of accounting is attributable to another period.

(g) The Commission shall, as soon as practicable after the expiration of the guaranty period, ascertain and certify to the Secretary of the Treasury the several amounts necessary to make good the foregoing guaranty to each carrier. The Secretary of the Treasury is hereby authorized and directed thereupon to draw warrants in favor of each such carrier upon the Treasury of the United States, for the amount shown in such certificate as necessary to make good such guaranty. An amount sufficient to pay such warrants is hereby appropriated out of any money in the Treasury not otherwise appropriated.

(h) Upon application of any carrier to the Commission, asking that during the guaranty period there may be advanced to it from time to time such sums, not in excess of the estimated amount necessary to make good the guaranty, as are necessary to enable it to meet its fixed charges, and operating expenses, the Commission may certify to the Secretary of the Treasury the amount of, and times at which, such advances, if any, shall be made. The Secretary of the Treasury, on receipt of such certificate, is authorized and directed to make the advances in the amounts and at the times specified in the certificate, upon the execution by the carrier of a contract, secured in such manner as the Secretary may determine, that upon final determination of the amount of the guaranty provided for by this section such carrier will repay to the United States any amounts which it has received from such advances in excess of the guaranty, with interest at the rate of 6 per centum per annum from the time such excess was paid. There is hereby appropriated, out of any money in the Treasury not otherwise appropriated, a sum sufficient to enable the Secretary of the Treasury to make the advances referred to in this subdivision."

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No. 634

In the Supreme Court of the United States

OCTOBER TERM, 1931

THE TEXAS & PACIFIC RAILWAY COMPANY,
PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES

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MEMORANDUM FOR THE UNITED STATES

We do not oppose the instant petition.

OPINION BELOW

The opinion of the Court of Claims (R. 13) is reported in 52 F. (2d) 1040.

JURISDICTION

The judgment sought to be reviewed was entered on October 20, 1931. (R. 17.) The petition for certiorari was filed on January 14, 1932. (R. 18.) The jurisdiction of this Court is evidently invoked under Section 3(b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether a sum paid to the petitioner by the Government as the guaranty of its railway operating income for the period of six months beginning March 1, 1920, pursuant to a certificate of the Interstate Commerce Commission, issued under Section 209 of the Transportation Act of 1920, was taxable income.

STATUTES INVOLVED

These are set forth in the Appendix, *infra*, pp. 4–6.

STATEMENT

The findings of the Court of Claims (R. 9–12) applicable to the point to which the instant petition relates may be abridged as follows:

The railway properties of the petitioner were operated by a receiver during the six months beginning March 1, 1920. (R. 9.) The petitioner accepted the provisions of Section 209 of the Transportation Act of 1920, and received for the period of six months beginning March 1, 1920, an allowance by the Interstate Commerce Commission representing the amount necessary to make good the guaranty under Section 209 in the sum of $2,043,041.77 and one of its subsidiaries received $18,040.86 under the same section. (R. 9.)

The petitioner and this subsidiary filed separate returns for income and excess profits for the year 1920. The Commissioner of Internal Revenue audited these returns and held that the subsidiary

company referred to and another company were affiliated with petitioner for 1920, and consolidated them for the purpose of the determination of their tax liability. (R. 10.) The consolidated net income of the petitioner and its subsidiaries, as finally determined by the Commissioner, included the allowances under Section 209 of the Transportation Act of 1920, which the taxpayers had not included in their original returns. The petitioner paid the amount assessed, based upon such determination; duly filed a claim for refund; and after it was rejected sued the United States in the Court of Claims. The Court of Claims decided in favor of the Government in respect of this item.

DISCUSSION

On account of the importance of this question and the large number of cases involving it which are pending, the Government does not oppose this petition. See memorandum for the United States in *Continental Tie & Lumber Co.* v. *United States*, No. 560.

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
CHARLES B. RUGG,
Assistant Attorney General.
CLAUDE R. BRANCH,
Special Assistant to the Attorney General.

JANUARY, 1932.

APPENDIX

STATUTES INVOLVED

Transportation Act, 1920, c. 91, 41 Stat. 456, 464:

SEC. 209 (a). When used in this section—

The term "carrier" means (1) a carrier by railroad or partly by railroad and partly by water, whose railroad or system of transportation is under Federal control at the time Federal control terminates, or which has heretofore engaged as a common carrier in general transportation and competed for traffic, or connected, with a railroad at any time under Federal control; and (2) a sleeping-car company whose system of transportation is under Federal control at the time Federal control terminates; but does not include a street or interurban electric railway not under Federal control at the time Federal control terminates, which has as its principal source of operating revenue urban, suburban, or interurban passenger traffic or sale of power, heat, and light, or both;

The term "guaranty period" means the six months beginning March 1, 1920.

The term "test period" means the three years ending June 30, 1917; and

The term "railway operating income" and other references to accounts of carriers by railroad shall, in the case of a sleeping-car company, be construed as indicating the appropriate corresponding accounts in the accounting system prescribed by the Commission.

(b) This section shall not be applicable to any carrier which does not on or before March 15, 1920, file with the Commission a written statement that it accepts all the provisions of this section.

(c) The United States hereby guarantees—

(1) With respect to any carrier with which a contract (exclusive of so-called co-operative contracts or waivers) has been made fixing the amount of just compensation under the Federal Control Act, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half the amount named in such contract as annual compensation, or, where the contract fixed a lump sum as compensation for the whole period of Federal operation, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than an amount which shall bear the same proportion to the lump sum so fixed as six months bears to the number of months during which such carrier was under Federal operation, including in both cases the increases in such compensation provided for in section 4 of the Federal Control Act;

* * * * *

(d) If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (1), (2), or (4) of subdivision (c) is in excess of the minimum railway operating income guaranteed in such paragraph, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (3)

of subdivision (c) is in excess of one-half of the annual sum fixed by the President with respect to such carrier under section 4 of the Federal Control Act, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. The amounts so paid into the Treasury of the United States shall be added to the funds made available under section 202 for the purposes indicated in such section. Notwithstanding the provisions of this subdivision, any carrier may retain out of any such excess any amount necessary to enable it to pay its fixed charges accruing during the guaranty period.

* * * * * *

(g) The Commission shall, as soon as practicable after the expiration of the guaranty period, ascertain and certify to the Secretary of the Treasury the several amounts necessary to make good the foregoing guaranty to each carrier. The Secretary of the Treasury is hereby authorized and directed thereupon to draw warrants in favor of each such carrier upon the Treasury of the United States, for the amount shown in such certificate as necessary to make good such guaranty. An amount sufficient to pay such warrants is hereby appropriated out of any money in the Treasury not otherwise appropriated.

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No. 634

In the Supreme Court of the United States

OCTOBER TERM, 1931

THE TEXAS & PACIFIC RAILWAY COMPANY,
PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 634

THE TEXAS & PACIFIC RAILWAY COMPANY, petitioner

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 13) is reported in 52 F. (2d) 1040.

JURISDICTION

The judgment sought to be reviewed was entered on October 20, 1931. (R. 17.) The petition for certiorari was filed on January 14, 1932, and the writ was granted February 15, 1932. (R. 18.) The jurisdiction of this Court rests on Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether a sum paid to the petitioner by the United States as the guaranty of its railway operating income for the six months period beginning March 1, 1920, pursuant to a certificate of the Interstate Commerce Commission, issued under Section 209 of the Transportation Act, 1920, was taxable income.

STATUTES INVOLVED

The statutes involved are set forth in Appendix A, *infra,* p. 19.

STATEMENT

The findings of the Court of Claims (R. 9–13) applicable to the point to which the instant petition relates may be abridged as follows:

The petitioner is a railroad corporation, and during the period of Federal control of railways was operated by the Government. (R. 9.) On March 1, 1920, the Government relinquished its control of the petitioner's properties to a receiver that was in charge of its offices. (R. 9.) The receiver operated the railroad during the six months beginning March 1, 1920. (R. 9.) The petitioner accepted the provisions of Section 209 of the Transportation Act, 1920 (*infra,* p. 19) and received for the period of six months beginning March 1, 1920, an allowance by the Interstate Commerce Commission, representing the amount necessary to make good the guaranty under Section 209, in the sum of $2,043,041.77, and one of its subsidiaries received

$18,040.86 under the same section. (R. 9.) The findings do not state when these payments were made.

The petitioner and this subsidiary filed separate returns for the year 1920. The Commissioner of Internal Revenue audited these returns and held that the subsidiary company referred to and another company were affiliated with the petitioner for 1920, and consolidated them for the purpose of the determination of their tax liability. (R. 10.) The consolidated net income of the petitioner and its subsidiaries, as finally determined by the Commissioner, included the allowances under Section 209 of the Transportation Act, 1920, which the taxpayers had not included in their original returns. The petitioner paid the amount assessed, based upon such determination, duly filed a claim for refund, and after it was rejected sued the United States in the Court of Claims. The Court of Claims decided in favor of the Government in respect of the item now in controversy.

SUMMARY OF ARGUMENT

When, on March 1, 1920, the railroads were returned to private ownership the transportation system of the country was disorganized. Most of the railroads of the United States lacked funds for necessary improvements, equipment, and expansion facilities. The credit of many carriers was seriously impaired. Congress deemed it important to preserve for the United States substantially the

whole existing transportation system. In order to do this it was thought necessary that the United States should to a certain extent finance the carriers temporarily. The provisions of Section 209 of the Transportation Act, 1920, were framed to that end.

The lines had suffered by Government regulation and by the routing of freight over competing lines which were under Federal control. The purpose of Section 209 was to reimburse railways like the petitioner's on account of a decrease in their net railway operating income because of Federal control. The legislative history shows that it was the intention of Congress to extend this aid in recognition not only of their financial necessities, but also to compensate for injury through Federal control.

The payments made under Section 209 were taxable income just as was compensation paid under the Federal Control Act. The payments were derived because of the operation of a railroad and consequently come within the definition of income as "gain derived from capital, from labor, or from both combined."

The payments here were not capital subsidies like those involved in *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628.

The payments are not exempt from the income tax as "property acquired by gift." The payments made under Section 209 were based upon moral and contractual obligations. The United States received consideration for the guaranty.

Congress could hardly have contemplated that the amount paid should be exempt from income tax. Such treatment would put the railroads receiving payments under Section 209 in a better position than the roads which had no such reimbursement.

ARGUMENT

THE SUMS PAID PURSUANT TO SECTION 209 OF THE TRANSPORTATION ACT, 1920, WERE TAXABLE INCOME TO THE PETITIONER

When, on the first of March, 1920, the railroads were returned to private ownership, the transportation system of the country was disorganized. Many of the roads were in poor financial condition. Congress realized that the public welfare required the stabilization of the system, and an effort was made in the Transportation Act, 1920, to restore the carriers to a position more like that which had antedated Federal control. This Court has considered the purpose of Congress in passing these statutory provisions. In *United States* v. *Guaranty Trust Company,* 280 U. S. 478, 484, it was stated:

> These appropriations were made in order to meet a pressing need. At the time of the passage of the Transportation Act, 1920, most of the railroads of the United States lacked funds for necessary improvements, equipment, and expansion of facilities. Some of the carriers needed funds, also, to meet maturing obligations. The credit of many carriers was seriously impaired. There was a general reluctance among investors to purchase new railroad securities

even of the strongest railroads. Congress deemed it important to preserve for the nation substantially the whole existing transportation system. Compare *New England Divisions Case,* 261 U. S. 184, 190. In order to accomplish this, it was thought necessary that the United States should, to a certain extent, finance the carriers until it would become possible to restore their credit, by increase of rates or otherwise. The provisions of Title II of Transportation Act, 1920, were framed to that end.

Section 209 of the Transportation Act, 1920 (*infra,* p. 19), provided for an agreement between the United States and those carriers which were released from Federal control in 1920. Those roads which by March 15, 1920, formally accepted all the provisions of Section 209 were guaranteed for the six months beginning March 1, 1920, a minimum operating revenue as great as that received by their operation for a similar period under Federal control. In return each road agreed that if its operating revenue should prove to be greater than the agreed minimum, it would turn over the excess to the United States.

The guaranty provided by this section was a recognition by Congress of a moral obligation to the railroads that had been under Federal control. Although under the provisions of the Federal Control Act the railroads had been compensated for injury suffered by them and just compensation within the meaning of the Fifth Amendment had

been made for all legal liability of the United States, the condition of the roads as a whole was desperate. The normal competitive relationship of the transportation system of the country had been thoroughly disorganized. The operation of the properties under Federal control had been for the primary purpose of promoting the military efficiency of the country. All railway lines had been merged under the management of the Director General of Railroads into a single nation-wide system. Traffic, both passenger and freight, whether publicly or privately owned, had been routed solely in the interest of the Government. The equipment of all railroads had in effect been pooled because of the military exigency, and was scattered all over the nation. *Gulf, Mobile & Northern Railroad Co.* v. *Commissioner,* 22 B. T. A. 233, 250. (See statement of Congressman Merritt, set forth in Appendix C, *infa,* p. 27.)

The continuing effect of the disturbing influence of Federal control was obviously to be of some duration when the Transportation Act was passed in February, 1920. The compensation paid under the Federal Control Act, although adequately liquidating all actual claims for damage recognized by that Act, did not attempt to compensate for this obligation to the carriers which was definite in character but then unknown as to extent and amount.

Furthermore, one of the primary purposes of the guaranty payments was to reestablish the credit

of the railroads. This was essential for their continued successful operation, not only to enable the sale of securities for the securing of funds necessary for operations, but also for permanent and capital improvements. Many railroads that had paid dividends under private operation had not earned interest charges under Federal control. (See statement by Congressman Esch, set out in Appendix C, *infra,* p. 29.) Although the provisions of the Transportation Act, 1920, contemplated governmental aid in the refunding of debts, etc., this aid was but a partial solution of the whole problem. The necessity for rehabilitation of the credit of the railroads was imperative. The expense of operation had been materially increased. The increase in wages in 1919 was practically $1,000,000,000 and the increase in 1920 was approximately $45,000,000 additional. (See statement by Congressman Esch, set out in Appendix C, *infra,* p. 29.)

Railroad rates had not been adjusted to meet this increased expense of operation. It was contemplated that the confidence of the investing public could be restored in the railroads only by an assurance of adequate earnings. The guaranteed earnings for the six-month period immediately following the restoration of the roads to the owners was to permit roads during that period to readjust themselves to individual operation and stabilize the transportation industry in such a manner as to

reestablish their undermined and disorganized credit, resulting from Federal control.

The Board of Tax Appeals aptly summarized the situation in *Kansas City Southern Railway Company* v. *Commissioner,* 22 B. T. A. 949, 953:

> This subnormal state, resulting from the Government's use of the properties for war purposes, could not be computed in dollars but it was recognized by the Government and responsibility therefor accepted. Whether the restoration of the prewar earning capacity of the railroads that had been under Government control was a legal obligation enforceable at law under the terms of the "standard contract" has never been decided by the courts because, in the postwar railway crisis, the Congress promptly conceded the responsibility of the Republic and settled a recognized obligation without requiring the carriers to resort to litigation.
>
> In the circumstances disclosed by the record and in the light of historical events within common knowledge, we conclude that the payment in question was in recognition of an obligation assumed by the Government when it temporarily sequestered the petitioner's railroad for war purposes.

Thus the payments under Section 209 of the Transportation Act, 1920 (*infra,* pp. 19–24) were in recognition of at least a moral obligation. We contend that they constituted income within the mean-

ing of the Sixteenth Amendment, as interpreted by this Court.

Furthermore, the obligations of the United States and the railroad under Section 209 were mutual and contractual. The road was entitled to no benefit under the statute until it accepted all the provisions of the section. Such an acceptance included a promise to pay the Government any excess of railway operating income over the minimum fixed by the statute. Whether or not the road would have to pay something to the Treasury under this provision could not definitely be determined by March 15, 1920, when the acceptance was required. The possibility of such payment depended upon the earnings of the road during the next six months. As the court below said (R. 14.):

> This constituted a contractual agreement between the carrier and the Government, and it could not be ascertained until an accounting had been had whether the Government would pay the railroad or whether the railroad would pay the Government. This feature of the case takes away any basis for holding that the payments by the Government were pure gifts or subsidies to the railroads.

It is true that the Government paid out substantially more under this provision of the Act than it received, but the obligations which any railroad incurred by accepting the provisions of the section were genuine and real. Over two million dollars

was collected by the United States under this provision. (See letter from the Interstate Commerce Commission, set forth in Appendix B, *infra,* p. 25.) The assumption of such obligations constituted a substantial consideration for the promise of Congress to guarantee a minimum operating income for the railroads. This was the opinion of the District Court for the Eastern District of South Carolina in *United States* v. *Hampton & Branchville Railroad Company,* not reported, when in a suit to recover excess revenue from a carrier the Government's motion for a directed verdict was granted in the following language (p. 81 of trial proceedings):

> As I view it, the Commission was authorized by the contract between the parties. All of these statutory provisions were embodied in this contract, and by the agreement of the parties they became a part of the contract, and by that contract the Commission was to fix the operating expense, and the maintenance of equipment, and the maintenance for right of way, and they did that on the books of the Company, and on data that they found there, and they certified the amount that is due, * * *.

We submit that the payments in this case were made pursuant to contract and hence are taxable income. The fact that the carriers' promise furnished consideration for the Government's payment was relied upon in the numerous decisions by the Board of Tax Appeals which have held that such

payments should be included in gross income. *Gulf, Mobile & Northern Railroad* v. *Commissioner,* 22 B. T. A. 233, 247; *Missouri Pacific Railroad Co.* v. *Commissioner,* 22 B. T. A. 267; *Kansas City Southern Railway Co.* v. *Commissioner,* 22 B. T. A. 949; *Galveston Wharf Co.* v. *Commissioner,* 22 B. T. A. 1312; *Chicago & Northwestern Railway Co.* v. *Commissioner,* 22 B. T. A. 1407; *International-Great Northern Railroad Co.* v. *Commissioner,* 24 B. T. A. 726, 739. There is no authority to the contrary.

The petitioner contends that this payment under Section 209 was not "income," and stresses the definition of income as "gain derived from capital, from labor, or from both combined." See *Eisner* v. *Macomber,* 252 U. S. 189, 207. But, accepting that definition, we submit it clearly includes gain such as the petitioner received by this reimbursement. There is no doubt that compensation paid under the Federal Control Act is taxable income. *Kansas City Southern Railway Co.* v. *Commissioner,* 52 F. (2d) 372, 379 (C. C. A. 8th), certiorari denied, 284 U. S. (Part 2) viii; *Gulf, Mobile & Northern Railroad Co.* v. *Commissioner,* 22 B. T. A. 233, 239. The purpose of the payment involved in the instant case was similar. The form of payment is not significant.

In *Hamilton* v. *Kentucky & Indiana Terminal R. Co.,* 289 Fed. 20 (C. C. A. 6th), it was held that payments by railroad companies to reimburse their subsidiary terminal company the amount of the latter's operating deficit were to be included in gross

income under the Revenue Act of 1917. In the instant case the payments were derived because of the operation of a railroad. Nothing was to be paid under Section 209 unless the railroad had been in active operation. Had the carrier's business been profitable, its earnings would clearly have constituted income. The amount of the payment by the Government depended upon the amount of the road's earnings, and took the place of operating income. The gain was derived from the road's operation just as much as if the money had been received from shippers in the form of freight rates instead of from the United States. This was pointed out by the Board of Tax Appeals in *Gulf, Mobile & Northern Railroad Co.* v. *Commissioner,* 22 B. T. A. 233, at 254, where identical payments were held taxable:

> It is contended by the petitioner that the payments did not come within the scope of this definition. The payments by the Government, however, were dependent upon the operation of the railroad, that is, the use of both capital and labor. The payments were not received for the guaranty period unless the railroads were in operation during that period, and then only in the event that their operating income was less than the guaranteed amount, and we can not overlook the fact that it was railway operating income which was guaranteed and made up. The Government derived a substantial benefit from the payments. It received consideration from the substantial good obtained for or expected to be obtained for the peo-

> ple as a whole on account of the more efficient operation of the railroads and the further establishment of their credit.

Petitioner also contends that the payments were capital subsidies and relies upon *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628. There this Court said (pp. 632–633) that the facts indicated that—

> The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. * * * Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered.

In the instant case, the payments were expressly a reimbursement of lost operating income and are not analogous to the capital subsidy involved in the *Cuba Railroad* case. There were no restrictions expressed or implied on the use by the railroads of the funds paid under Section 209. As previously indicated, the moneys were paid in recognition of an existing obligation. Although the obligation was perhaps not legally enforceable, it was of a nature that appealed to Congress as compelling and unavoidable, and Congress recognized it by passing the statute. The obligation arose from diminished operating revenue, rather than from impaired capital investments. In a case identical

with the instant one, *Kansas City Southern Railway Co.* v. *Commissioner,* 22 B. T. A. 949, 951, the Board of Tax Appeals characterized the nature of these payments with these words:

> The petitioner received the guaranty payment free from limitations or restrictions and from the date of such receipt it was available for all corporate purposes to which income may be applied. It could be used for the payment of dividends or operating expense, or it could be invested in capital additions.
>
> This is in sharp contrast with the single use which could be made of the subsidy in the *Cuba* case, which we think is in no wise controlling in the circumstances herein.

The nontaxability of these payments under Section 209 would be inconsistent with the purpose of Congress in enacting that statute. Congress desired to restore the competitive balance of the railroads which had existed prior to Federal control. It was sought to strengthen the carriers that had been injured by Federal control so that they would again be competitors in the transportation business. There was no purpose to place these weaker roads which Congress was reimbursing in a better position than the stronger carriers which showed no decrease in operating revenue in order to secure compensation. Yet that is exactly what would happen if these payments should be held tax exempt.

Thus, assume that railroads A and B are each guaranteed a $750,000 revenue under Section 209. During the guaranty period, carrier A earns the $750,000, but B has no railway operating income. A payment of $750,000 is made to railroad B. Road A is, of course, taxed upon its $750,000 operating revenue. But carrier B receives a Government payment of $750,000 tax free, and as a result is better situated financially than its competitor. Such an unreasonable result could hardly have been intended by Congress in passing Section 209.

The petitioner further contends that these payments were *gratuities*. The Government maintains that in exempting from gross income "the value of property acquired by gift" in Section 213 (b) (3) of the Revenue Act of 1918, Congress had no intention of rendering nontaxable the payment received by the petitioner in the instant case. Furthermore, as has been pointed out, the carriers gave consideration for the payments.

Even if there were no legal consideration for the payment, that would not make the payment a gift. Many decisions have held taxable payments made by corporations to officers as compensation for past services which had already been fully paid for. *Noel* v. *Parrott*, 15 F. (2d) 669 (C. C. A. 4th), certiorari denied, 273 U. S. 754; *Schumacher* v. *United States*, (C. Cls.) decided February 8, 1932, reported in 1932 Prentice-Hall Federal Tax Service at Paragraph 795. In the instant case Congress felt obligated to reimburse the railroads and the

mere fact that until the statute was enacted the carriers had no cause of action in a court of law does not render the payment a gratuity. In *Williams* v. *Heard*, 140 U. S. 529, in speaking of the awards by the Court of Commissioners of Alabama Claims, where there was no legally enforceable obligation prior to the statute, this Court said (p. 541):

> Neither do we think that the money appropriated by Congress by the act of 1882 to pay these claims should be considered merely as a gratuity.

CONCLUSION

The decision below is correct. No court has decided the question otherwise. The judgment of the Court of Claims should be affirmed.

Respectfully submitted.

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APRIL, 1932.

APPENDIX A

STATUTES INVOLVED

Section 213 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1065, provides in part:

> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> * * * * *
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (3) The value of property acquired by gift, * * *

Section 209 of the Transportation Act of 1920, c. 91, 41 Stat. 456, 464, U. S. C., Title 49, Section 77, provides in part:

> SEC. 209. (a) When used in this section—
>
> The term "carrier" means (1) a carrier by railroad or partly by railroad and partly by water, whose railroad or system of transportation is under Federal control at the time Federal control terminates, or which has heretofore engaged as a common carrier in general transportation and competed for traffic, or connected, with a railroad at any time under Federal control; and (2) a sleeping car company whose system of transportation is under Federal control at the time

Federal control terminates; but does not include a street or interurban electric railway not under Federal control at the time Federal control terminates, which has as its principal source of operating revenue urban, suburban, or interurban passenger traffic or sale of power, heat, and light, or both;

The term "guaranty period" means the six months beginning March 1, 1920;

The term "test period" means the three years ending June 30, 1917; and

The term "railway operating income" and other references to accounts of carriers by railroad shall, in the case of a sleeping-car company, be construed as indicating the appropriate corresponding accounts in the accounting system prescribed by the Commission.

(b) This section shall not be applicable to any carrier which does not on or before March 15, 1920, file with the Commission a written statement that it accepts all the provisions of this section.

(c) The United States hereby guarantees—

(1) With respect to any carrier with which a contract (exclusive of so-called co-operative contracts or waivers) has been made fixing the amount of just compensation under the Federal Control Act, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half the amount named in such contract as annual compensation, or, where the contract fixed a lump sum as compensation for the whole period of Federal operation, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than an amount which shall bear the same proportion to the lump sum so fixed as six months bears to the number

of months during which such carrier was under Federal operation, including in both cases the increases in such compensation provided for in section 4 of the Federal Control Act;

(2) With respect to any carrier entitled to just compensation under the Federal Control Act, with which such a contract has not been made, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half of the annual amount estimated by the President as just compensation for such carrier under the Federal Control Act, including the increases in such compensation provided for in section 4 of the Federal Control Act. If any such carrier does not accept the President's estimate respecting its just compensation, and if in proceedings under section 3 of the Federal Control Act it is determined that a larger or smaller annual amount is due as just compensation, the guaranty under this paragraph shall be increased or decreased accordingly;

(3) With respect to any carrier, whether or not entitled to just compensation under the Federal Control Act, with which such a contract has not been made, and for which no estimate of just compensation is made by the President, and which for the test period as a whole sustained a deficit in railway operating income, the guaranty shall be a sum equal to (a) the amount by which any deficit in its railway operating income for the guaranty period as a whole exceeds one-half of its average annual deficit in railway operating income for the test period, plus (b) an amount equal to one-half the annual sum fixed by the President under section 4 of the Federal Control Act;

(4) With respect to any carrier not entitled to just compensation under the Federal Control Act, which for the test period as a whole had an average annual railway operating income, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half the average annual railway operating income of such carrier during the test period.

(d) If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (1), (2), or (4) of subdivision (c) is in excess of the minimum railway operating income guaranteed in such paragraph, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (3) of subdivision (c) is in excess of one-half of the annual sum fixed by the President with respect to such carrier under section 4 of the Federal Control Act, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. The amounts so paid into the Treasury of the United States shall be added to the funds made available under section 202 for the purposes indicated in such section. Notwithstanding the provisions of this subdivision, any carrier may retain out of any such excess any amount necessary to enable it to pay its fixed charges accruing during the guaranty period.

(e) For the purposes of this section railway operating income, or any deficit therein, for the test period shall be computed in the manner provided for in section 1 of the Federal Control Act.

(f) In computing railway operating income, or any deficit therein, for the guaranty period for the purposes of this section—

(1) Debits and credits arising from the accounts, called in the monthly reports to the Commission equipment rents and joint facility rents, shall be included, but debits and credits arising from the operation of such street electric passenger railways, including railways commonly called interurbans, as are not under Federal control at the time of termination thereof, shall be excluded;

(2) Proper adjustments shall be made (a) in case any lines which were, during any portion of the period of Federal control, a part of the railroad or system of transportation of the carrier, and whose railway operating income was included in such income of the carrier for the test period, do not continue to be a part of such railroad or system of transportation during the entire guaranty period, and (b) in case of any lines acquired by, leased to, or consolidated with, the railroad or system of transportation of the carrier at any time since the end of the test period and prior to the expiration of the guaranty period, for which separate operating returns to the Commission are not made in respect to the entire portion of the guaranty period;

(3) There shall not be included in operating expenses, for maintenance of way and structures, or for maintenance of equipment, more than an amount fixed by the Commission. In fixing such amount the Commission shall so far as practicable apply the rule set forth in the proviso in paragraph (a) of section 5 of the "standard contract" between the United States and the carriers (whether or not such contract has been entered into

with the carrier whose railway operating income is being computed);

(4) There shall not be included any taxes paid under Title I or II of the Revenue Act of 1917, or such portion of the taxes paid under Title II or III of the Revenue Act of 1918 as by the terms of such Act are to be treated as levied by an Act in amendment of Title I or II of the Revenue Act of 1917; and

(5) The Commission shall require the elimination and restatement of the operating expenses and revenues (other than for maintenance of way and structures, or maintenance of equipment) for the guaranty period, to the extent necessary to correct and exclude any disproportionate or unreasonable charge to such expenses or revenues for such period, or any charge to such expenses or revenues for such period which under a proper system of accounting is attributable to another period.

(g) The Commission shall, as soon as practicable after the expiration of the guaranty period, ascertain and certify to the Secretary of the Treasury the several amounts necessary to make good the foregoing guaranty to each carrier. The Secretary of the Treasury is hereby authorized and directed thereupon to draw warrants in favor of each such carrier upon the Treasury of the United States, for the amount shown in such certificate as necessary to make good such guaranty. An amount sufficient to pay such warrants is hereby appropriated out of any money in the Treasury not otherwise appropriated.

* * * * *

APPENDIX B

INTERSTATE COMMERCE COMMISSION,
OFFICE OF THE SECRETARY,
Washington, March 5, 1932.

George B. McGinty, Secretary. Finance Docket No. 834

The Honorable CHARLES B. RUGG,
Assistant Attorney General,
Washington, D. C.

DEAR SIR: Acknowledgment is made of your letter of the 2d instant, initials JHS, in re: *Texas & Pacific Railway Co.* v. *U. S., Sup. Ct.* No. 634. In response to your request for certain information I attach hereto a statement showing the names of all carriers and the amounts earned by each in the guaranty period in excess of the test period income and therefore subject to the provisions of subdivision (d) of section 209 of the transportation act, 1920. This statement also shows citation of the Commission's reports covering these cases.

This statement has been compiled to show the carriers having an independent status with excess income of $452,833.38 and those included in group or system settlements which reduced the amounts otherwise payable in the aggregate amount of $2,358,023.52, a total excess income of $2,810,856.90.

The net amount certified to the Treasury as due railroads under the provisions of the above-mentioned Act in settlement to date of 523 claims is

$528,985,521.20. This latter figure is inclusive of the amount of $2,810,856.90, shown above as due from certain railroads.

Very truly yours,

G. B. McGINTY, *Secretary.*

Enclosure.

Statement showing carriers which have been certified to the Secretary of the Treasury under the provisions of section 209 of the transportation act, 1920, as having earned an income in the guaranty period in excess of the income earned in the test period.

Independent carriers	F. D.	Excess income in guaranty period	Citation
Ahnapee & Western	252	$2,940.39	76 I. C. C. 660.
Barre & Chelsea	301	28,391.33	79 I. C. C. 343.
Campbell's Creek	334	3,560.52	86 I. C. C. 695.
Carolina R. R	336	910.78	82 I. C. C. 173.
E. Tennessee & W. No. Carolina	451	10,473.42	79 I. C. C. 52.
Gilmore & Pittsburg	489	1,427.11	99 I. C. C. 247.
Hampton & Branchville	514	4,768.46	117 I. C. C. 341.
Ironton R. R	541	1,935.77	79 I. C. C. 455.
Kewaunee Green Bay & West	563	260.50	76 I. C. C. 699.
Kishacoquillas Ry	565	2,707.79	82 I. C. C. 565.
Lake Tahoe Ry. & Transp	574	5,694.23	76 I. C. C. 537.
Louisiana Western	596	168,397.58	79 I. C. C. 401.
Massena Terminal	616	7,399.44	79 I. C. C. 525.
Missouri & Illinois Bdg. & Belt	644	20,395.56	90 I. C. C. 633.
Rosslyn Connecting	774	5,677.03	90 I. C. C. 747.
Sandy Valley & Elkhorn	780	189,944.79	99 I. C. C. 236.
South Manchester	795	1,079.16	82 I. C. C. 167.
Yreka R. R	915	562.52	99 I. C. C. 760.
Total		452,833.38	
INCLUDED IN SYSTEM SETTLEMENT			
Beaumont Sour Lake & Wes	306	71,242.62	82 I. C. C. 513.
Lake George Steamboat Co	572	10,986.32	94 I. C. C. 253.
Los Angeles & Salt Lake	592	326,330.34	82 I. C. C. 486.
Louisiana & Miss. River Trans	593	3,065.10	86 I. C. C. 3.
Union Pacific	855	1,946,399.14	82 I. C. C. 486.
Total		2,358,023.52	
Grand total		2,810,856.90	

APPENDIX C

EXCERPTS FROM CONGRESSIONAL RECORD

Remarks by Mr. Merritt, of the Commerce Committee, reported in Vol. 58 of the Congressional Record, page 8342:

> The conditions are that these roads, not by their own desire but by the exigency of war and by the operation of law, were taken over by the United States and had been run by the United States for about two years. I do not say this by way of criticism, but the fact is that the operation of the railroads by the United States has produced a great deficit. There is a continuing deficit to-day. The personnel of the roads has been disturbed. The property of the roads, in the shape of cars, is all over the United States, and it will take a large amount of time and a great amount of expense for each road to get its property together, to get its personnel together, and to go on running as a separate entity.
>
> That is the reason why the committee has allowed this period of six months under the present guaranty, so that the roads may get new rates before the commission, and get their business started under these new rates, so that when the guaranty ends they may be on their own feet and may go on in a self-supporting way.

Remarks by Mr. Esch, for the Commerce Committee, of the 66th Congress, reported in the Congressional Record, Volume 58, page 8453:

Mr. Chairman, the necessity for maintaining the guaranty for a period of six months must be evident to everyone who realizes the tremendous increase in cost of the operation imposed on the carriers, as was suggested by the gentleman from Vermont, by fiat. The railroads did not have anything to say about the amount or as to the cost of material. That was fixed by governmental agency. The total increase of wages in 1919 through Government agency was practically $1,000,000,000. The increase this year will possibly be larger than that by reason of the fact that the shopmen have recently had an increase granted through the Director General, retroactive to the 1st of May, which will increase the wage scale $45,000,000 per annum.

Now, under these circumstances we felt that we were obligated to maintain this standard return for a period of six months until such time as the Interstate Commerce Commission could adjust the level of rates to meet the increased cost. We are paying the deficit which has occurred under Federal control. We hope that when the roads are returned through the standard return guaranty of six months the commission will adjust the level of rates so as to permit the roads to stand alone. That is why we are putting in the guaranty.

Remarks by Mr. Esch, for the conference committee of the 66th Congress, reported in the Congressional Record, volume 59, page 3268:

But the question will be raised why we should guarantee at all. When Federal control ceases why not have the guaranty of the Government for a standard return also cease? The reason lies in the financial straits

of the carriers when Federal control shall cease.

What is the situation? Prior to the war 60.38 per cent of the roads of class 1 earned a dividend and paid their interest. The balance did not. During the period of Federal control only 57 of the 175 class 1 roads earned their interest and only a few paid dividends. One hundred and eight of them did not earn their interest, and, of course, could not pay dividends, and many did not earn their operating expenses.

With this situation confronting the carriers on the 1st day of March, the committee of conference indorsed the attitude of both Senate and House, continuing the guaranty in the House bill for a straight term of six months.

In 1919, 108 class 1 roads lacked $60,000,000 of earning their interest and fixed charges. The net operating income last year was only practically half of the standard return which we guaranteed. Should we thrust these roads on their own resources on the 1st of March without a guaranty, I make the prediction that within three months 50 per cent of them would go into receiverships. Do we want to do that? Ought we to do it? No; because receiverships for railroads means receiverships for industrial plants and all classes of business throughout the country.

U. S. GOVERNMENT PRINTING OFFICE: 1920

SUPREME COURT OF THE UNITED STATES.

No. 634.—October Term, 1931.

The Texas & Pacific Railway Company, Petitioner, *vs.* The United States. } On Writ of Certiorari to the Court of Claims.

[May 16, 1932.]

Mr. Justice Roberts delivered the opinion of the Court.

During federal control of railways that of petitioner was operated by the Director General under the act of March 21, 1918.[1] Pursuant to the Transportation Act, 1920,[2] the Government relinquished the property March 1, 1920; petitioner accepted the provisions of § 209[3] of the act, and consequently received for the six months period commencing March 1, 1920, an allowance awarded by the Interstate Commerce Commission to make good the guaranty embodied in that section. The company omitted this sum from taxable income returned for the year 1920. After audit the Commissioner of Internal Revenue added the amount to the petitioner's income and assessed a resulting additional tax, which was paid under protest. Upon rejection of a claim for refund, suit was brought in the Court of Claims to recover the portion of the tax attributable to the inclusion of the guaranty payment, petitioner asserting that the amount received was a subsidy or gift and therefore not income within the Sixteenth Amendment of the Constitution or § 213 of the Revenue Act of 1918.[4] Recovery was denied. This court granted certiorari.

[1] Ch. 25, 40 Stat. 451.

[2] Act of February 28, 1920, c. 91, 41 Stat. 456.

[3] 41 Stat. 464; U. S. C., Tit. 49, § 77.

[4] 40 Stat. 1057, 1065. "That for the purposes of this title . . . the term 'gross income' . . . (b) Does not include . . . (3) The value of property acquired by gift" . . .

By the terms of § 209 of the Transportation Act railroad companies which, like petitioner, had made contracts with the Director General for annual compensation during federal control, were guaranteed an operating income for the ensuing six months of not less than one-half the amount of such compensation. A minimum operating revenue was also assured to carriers not having such contracts, which had been under federal control or adversely affected thereby. Payment was conditioned on the carrier's acceptance of the provisions of the section, one of which was the agreement that if operating revenue for the period should exceed the guaranteed amount the excess should be paid into the Treasury. Petitioner signified its acceptance.

The statute in terms guarantees a "*minimum operating income*" for six months after relinquishment of federal control. The situation in which the railroads of the country were as a result of war-time Government operation is well described in *United States* v. *Guaranty Trust Company*, 280 U. S. 478, 484. During that period their expenses had risen and there had been no commensurate increase in rates. While the Government had either paid or was obligated to pay just compensation for their requisition, the amount of it was known to be insufficient for rehabilitation of the roads as privately owned and operated organizations. Until rates could be adjusted to meet increased expenses, loans be negotiated, and operating forces realigned and reintegrated, the credit of the carriers must by some means be re-established. Thus the Government had a real obligation, not readily susceptible of accurate measurement, to assist in the restoration of normal conditions. The purpose of the guaranty provision was to stabilize the credit position of the roads by assuring them a minimum operating income. They were bound to operate their properties in order to avail themselves of the Government's proffer. Under the terms of the statute no sum could be received save as a result of operation. If the fruits of the employment of a road's capital and labor should fall below a fixed minimum then the Government agreed to make up the deficiency, and if the income were to exceed that minimum the carrier bound itself to pay the excess into the federal treasury. In the latter event the carrier unquestionably would have been obligated to pay income tax measured by actual earnings; in the former, it ought not to be in a

better position than if it had earned the specified minimum. Clearly, then, the amount paid to bring the yield from operation up to the required minimum was as much income from operation as were the railroad's receipts from fares and charges.

The sums received under the act were not subsidies or gifts,—that is, contributions to the capital of the railroads,—and this fact distinguishes cases such as *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628, where the payments were conditioned upon construction work performed. Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied. The Government's payments were not in their nature bounties, but an addition to a depleted operating revenue consequent upon a federal activity.

In a proper sense these payments constituted income to the carrier not exempt from taxation under the Sixteenth Amendment or the Revenue Act of 1918. The Court of Claims was right in denying the claim and the judgment must be

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.